COMMONWEALTH OF KENTUCKY
KENTON CIRCUIT COURT
FOURTH DIVISION
CASE NO. 07-CI-2647

WILLIAM J. YUNG

and

MARTHA A. YUNG **PLAINTIFFS**

v.

GRANT THORNTON LLP

and

THE 1994 WILLIAM J. YUNG FAMILY TRUST **DEFENDANTS**

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FINDINGS OF FACT AND CONCLUSIONS OF LAW AND JUDGMENT

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This case came to trial before the court beginning on April 10, 2012, and continued through May 4, 2012. The parties were present and represented by counsel throughout the proceedings.

ORDER

Objections not otherwise ruled upon at trial or addressed in this judgment are hereby **OVERRULED**.

FINDINGS OF FACT

THE PARTIES

I. PLAINTIFFS William & Martha Yung

1. Plaintiff William J. Yung (―Yung") is a successful hotelier and entrepreneur. He is the principal shareholder, chairman, and president of Columbia Sussex Corporation (―CSC"), a privately held hospitality company headquartered in Crestview Hills, Kentucky. He is an

experienced business man who owns and oversees many corporations, limited partnerships, and trusts. (W. Yung Test. 198:1-6, 291:20-292:12(4/11/12); T. Mitchel Test. 793:4-795-795:4 (4/18/12); J. Michel Test. 3508:4-15 (5/15/12); Williams Test. 3443: 16-3444:2 (5/15/12)).

Yung founded CSC in 1972 with the acquisition of his first hotel, a Days Inn in Edgewood, Kentucky. CSC, a subchapter S corporation of which Yung owns 51% and the ‘94 Trust owns 49%, is the primary organization of the hotel businesses. CSC currently owns approximately 40 hotels throughout the United States. (Trial Tr. 197:1-199:13 (W. Yung Test.)).

In 1990, Yung entered the gaming business through his acquisition of a hotel and casino in Lake Tahoe, Nevada. (Trial Tr. 200:10-200:18 (W. Yung Test.); Trial Tr. 607:19-608:8 (T. Mitchel Test.)). Yung set up Wimar Tahoe Corporation (―WTC”), a subchapter S corporation owned 100% by Yung, to purchase the hotel. (Trial Tr. 201:1-201:8 (W. Yung Test.)). Over the next 12 years, WTC purchased casinos in Mississippi, Nevada, and Louisiana. (Trial Tr. 609:3-609:15 (T. Mitchel Test.)).

Yung also owns hotels and casinos in the Cayman Islands through Wytec, Ltd., and Casuarina Cayman Holdings, Ltd., Cayman Island holding corporations, which are the entities used to purchase the Grant Thornton 30l Leveraged Distribution Product (―Lev301”), the subject of this litigation. Casuarina Cayman Holdings is owned 2% by Yung individually and 98% by the ‘94 Trust; Wytec was owned 2% by Yung individually and 98% (49% each) by two Grantor Retained Annuity Trusts (one for the benefit of Yung and one for the benefit of Mrs. Yung, and hereinafter jointly the ‘97 GRAT‘s), and at the expiration of the ‘97 GRATs is owned entirely by Yung and his wife; Yung is president and holds all of the voting stock of both of those companies; these two companies own hotels in the Cayman Islands and are controlled foreign corporations (hereinafter jointly the CFCs). The CFCs are not obligated to make distributions to their shareholders so profits could accumulate in the Caymans with no federal tax consequences. Two virtually identical sets of documents were used to effect the same transactions for the two CFCs: hereinafter when reference is made to one of the companies, e.g. ―the Wytec opinion letter," or ―the Casuarina transactions," the same analysis applies to both of these corporations.

The corporations and the '97 GRAT's are not parties to this case.

In 2000, the number of tax returns for CSC and the partnerships, trusts, and individuals affiliated with it totaled ―probably close to 100 returns" a year. (T. Mitchel Test. 3509:11-18(5/15/12)). Grant Thornton reviewed those 100 tax returns a year for CSC and its associates. (J. Michel direct testimony).

2. Plaintiff Martha A. Yung married Yung in 1963. (Trial Tr. 486:5-486:10 (M. Yung Test.)). She relies on Yung for business decisions and tax returns, and shares in the gains and losses of their businesses. (M. Yung 486:2-487:8 (4/11/12)). Together they have seven children. (PX 651).

II. Plaintiff's Associates

3. Joseph Yung (―Joe Yung"), one of the Yungs' sons, is CSC's Vice President of Development and acts as an advisor to his father Bill Yung. He was a proponent of the Lev301 product as he believed it would eliminate much of the travel required by his position.

4. Derek Haught, one of the Yungs' sons-in-law, works in the finance area of CSC and assisted with the communication of the Lev301 financial transaction with the lending institutions.

5. Joe Marquet (―Marquet") was a long-time management employee of Yung who functioned primarily as Vice President of Finance or Chief Financial Officer for CSC. He also dealt with Grant Thornton on behalf of Yung. He resigned his position in January 2001.

6. Ted Mitchel (“T. Mitchel”) joined CSC in 1989 as its Secretary Treasurer. He advanced to positions of Chief Financial Officer and a vice-president of the company. Prior to being hired by CSC, T. Mitchel worked at Coopers & Lybrand, a public accounting firm, where he provided audit related services but did not provide tax advice to clients. (Trial Tr. 601:15-603:10 (T. Mitchell Test.)). At CSC he was the primary contact between Yung and Grant Thornton and managed much of the relationship between the entities.

7. Sara Williams (“Williams”) joined CSC in 1999 as its tax director; prior to that time she was a tax manager in the Cincinnati office of Grant Thornton where she had worked on the CSC account. In December of 1999 she left CSC and returned to Grant Thornton, where she assisted with the Yung account including preparing and reviewing some of the tax returns for the Yungs and the ‘94 Trust.

8. Tom Drake (“Drake”) joined CSC as its tax director in 2003. He became aware of articles regarding the Lev301 and communicated with Grant Thornton.

9. Rich Fitzpatrick (“Fitzpatrick”) was Chief Financial Officer of CSC in 2007.

NOTE: When reference is made to “the Yungs” in general, it indicates the Yung family members, businesses and the trusts, including the ‘94 Trust (see below), together as their interests are aligned; many of the e-mails by Grant Thornton also refer generally to the Yungs as Columbia Sussex or CSC.

III. DEFENDANT Grant Thornton LLP and Associates

10. Defendant Grant Thornton LLP (“Grant Thornton” or “the Firm”) is a public accounting firm headquartered in Chicago, Illinois. The Firm offers audit, tax and business consulting services, and targets mostly middle market companies for those services. (Trial Tr. 2879:4-12 (Stutman Test.)). In the years 2000 to 2003, Grant Thornton earned revenues in excess of $1

billion. (*Id*. at 2896:10–11). Grant Thornton is governed by its partnership board which is comprised of 10 elected partners including the CEO. Grant Thornton had been retained by plaintiffs, primarily for tax advice, from some time in 1995 or 1996 through some time in 2007.

11. Stephen Chipman (―Chipman”) is the current CEO of Grant Thornton and a member of the board. (*Id.* at 2877:17-22, 2880:13-17). He testified to the ―collaborative management” style of the firm.

12. Mark Stutman (―Stutman”) is a member of the partnership board and is the national managing partner of tax services. In 1999, Stutman became managing partner of Grant Thornton‘s National Tax Office (―NTO”) in Washington, D.C.; in 2002 he became the national managing partner of tax services. Prior to taking on NTO position, Stutman was the managing partner of tax for the Philadelphia office of Grant Thornton. (*Id*. at 2876:11-2877:16). Stutman was responsible for overseeing the ―collaborative management” of the upper ranks of Grant Thornton in the United States, including the Lev301 strategy. He was involved in the Think Tank meetings and authored and received e-mails regarding the Lev301.

13. Ben Horak (―Horak”) was the managing partner of tax services through 2002. Prior to being appointed to that role, Horak was a partner in the Minneapolis office of Grant Thornton. Horak was involved with the sales and management of the Lev301. Horak was involuntarily terminated by Grant Thornton in 2003 (*Id*. at 3030:19-3031:11), and was replaced by Stutman. Horak was involved in the promotion and coordination of the product and was present at the Think Tank meetings. He authored and received many of the e-mails.

14. Dean Jorgensen (―Jorgensen”) is Grant Thornton‘s current New York and northeast region tax practice leader. (Trial Tr. 3040:4-12, 3040:25-3041:13, (Jorgensen Test.)). Jorgensen joined Grant Thornton in 1985 (which was then called Alexander Grant) as a tax supervisor in

the Minneapolis office. (*Id*. at 3050:1-3051:5). In 1997, Jorgensen transferred to the NTO, becoming a full equity partner of the firm in 1998. *Id*. By 1999, Jorgensen was the NTO's sole sub-chapter C-corporation tax specialist. (J. Michel Dep. 213:20-231:12, Oct. 28, 2011 (Vol. 1)). Jorgensen replaced Stutman as the managing partner of the NTO in 2002, and held that position until 2007. Jorgensen was instrumental in the research and development of the Lev301 tax product and was the technical resource leader. (Trial Tr. 3040:25-3041:13. (D. Jorgensen Test.)). He was the head of the sales team that marketed, advised and sold the Lev301 to the Yungs. He was the initial opinion writer for the Yung Opinions, including the December 29, 2000, opinion. He was involved in the Think Tank meetings and authored and received many of the e-mails.

15. John Michel (―J. Michel") is a former partner of Grant Thornton. J. Michel joined Grant Thornton in 1994 in the Firm's Cincinnati office. (PX 1045; Trial Tr. 3507:15 (J. Michel Test.)). In 1998, J. Michel was made a full equity partner of the firm. (PX 1045). Between 2001 and 2003, J. Michel was a member of the Firm's Federal Tax Products Group (―FTPG"). J. Michel was the primary relationship contact with Yung and those working for Yung including Marquet, T. Mitchel and Joe Yung. He was the point person for the sale of Lev301 to Yung and for the Yungs' tax return preparation and review. (Trial Tr. 3396:19-24 (J. Michel Test.)). He was involuntarily terminated by the Firm in 2009. (PX1045). He was involved in some of the internal meetings as well as the meetings with the Yungs, and authored and received many of the e-mails.

16. Richard Voll (―Voll") is a former partner of Grant Thornton. Voll joined the Firm in 2000 to provide experience in the area of corporate tax shelters and opinion letter writing. (Voll Dep. 13:23-14:5, 19:18-23, 29:21-30:8, Nov. 8, 2011 (Vol. 1)). Voll, a lawyer by training, was heavily involved in the secondary development, elaboration and advancement of the Lev301 tax

product. (*See id.*). He was involuntarily terminated by the Firm in 2003. (*Id*. at 38:19-21). He was involved in the meetings and authored and received many of the e-mails.

17. Chris Carlson (―Carlson") was head of the FTPG. He was an advocate for sales of products that would compete with the Big Five Accounting Firms and thereby increase revenue. He was the head of the salesmen. He was involved in the meetings and the e-mails. He has since died, so his involvement is limited to evidence of sent and received e-mail and other correspondence.

18. Bryan Keith (―Keith) was a junior member in the NTO. The evidence indicates that he was very involved in the initial research of the Lev301 with Jorgenson and the listing and reporting requirements with Stutman. He was involved in the Think Tank meetings, communication issues and the e-mails.

19. Michael Gould (―Gould"), an attorney, joined Grant Thornton in June 2001. He was assigned to assist with the writing of tax opinions for the Lev301. He was included in Lev301 research and e-mail communications.

20. Goodarz Agahi (―Agahi") worked in the NTO from January 2002 through early summer 2004. He was assigned to assist with the writing of tax opinions for Lev301. He was included in Lev301 research and e-mail communications.

21. Thomas Bottiglieri (―Bottiglieri") was a tax partner in the New York office of the firm, referred to as a field partner. He introduced the Lev301 to several clients and expressed concerns about the product from his study and from his client's research. He was privy to the Client Matrix; based on communications with members of the NTO he would set aside his concerns when the experts in the NTO stressed their belief that the Lev301 was correct at a ―more likely than not" confidence level.

22. Joseph Serafino (―Serafino”) was a partner in the Cincinnati office of the firm. He knew T. Mitchel and was the introducing agent for Grant Thonton and J. Michel to the Yung accounts.

23. Jeffrey Frishman (―Frishman”) was a partner in charge of tax practice policy and quality. He was hired to help in the management of the conflicts and ethical issues at Grant Thornton. In 2002 he began managing the issues surrounding the Lev301 product.

24. Peter Hurley (―Hurley”) worked with J. Michel on the sales side of the product. He was considered as the ―get it done” person for Carlson who was the sale development person. He explains his job as tracking sales. E-mails in evidence indicate he had a full knowledge of the Lev301. He was heavily involved with Lev301 presentations and management of the product.

25. Martin Van Brauman (―VanBrauman”) was a Grant Thornton sales person who expressed concern about the Lev301 to the NTO management.

26. Won Shin (―Shin”) was a Grant Thornton tax senior associate who conducted research on statutory construction issues for the Lev301 through 2001. He was involved in the development of the Lev301 as evidenced by the e-mail communications.

27. David Burnett (―Burnett”) was a member of the staff of the NTO of Grant Thornton. He was copied on the e-mails and had the opportunity for input on the Lev301. He was present at Think Tank meetings.

28. David Auclair (―Auclair”) was a partner in the NTO of Grant Thornton. He also was copied on the e-mails and had the opportunity for input on the Lev301.

29. Scott Hendon (―Hendon”) was present at the Think Tank meeting and developed the agenda for the June 21, 2000, phone conference on the Lev301. He was e-mailed copies of the Lev301 drafts and was copied on various other e-mails involving the product.

30. The following Grant Thornton personnel are mentioned in this opinion as having been in attendance at meetings or in receipt of e-mails regarding the Lev301 but are considered by the court to have been ancillary to the work thereon and therefore it is unnecessary to describe their roles in more detail: Bell, Wittmer, Ziegelbauer, Becker, Wagner, Kuck, Murphy, Brezak, and Quimby.

31. Peter Connors (―Connors”) is a tax lawyer in the firm of Baker & McKenzie who rendered advice to Grant Thornton on the Lev301, the completeness and formality of which is contested by the parties to this action. His advice is referred to on the Client Matrix as supportive of the Lev301 when in actuality it was not.

32. Dan Dumezich is a partner in the law firm of Mayer, Brown and Maw. He was a former employee of Grant Thornton, and his firm represented Grant Thornton in other matters. J. Michel recommended him to Yung for advice on the IRS audit. He communicated with J. Michel and Frishman regarding the Lev301.

D. ADDITIONAL PARTY, The 1994 William J. Yung Family Trust

33. The 1994 William J. Yung Family Trust (―‘94 Trust”) was created by Yung in 1994 to benefit his seven children. (PX 651). The ‘94 Trust is designated a defendant although its interest are more aligned with those of the plaintiffs. The ‘94 Trust is organized and exists under the laws of the State of Ohio. (PX 651). Between 1997 and 2001, Fifth Third Bank, N.A. (―Fifth Third”) was the trustee. (PX 651). U.S. Bank, N.A. (―U.S. Bank”), the current trustee, succeeded Fifth Third in that role. (PX 651). Joe Yung was appointed as the investment advisor for the ‘94 Trust in 1996. (PX 651). Joe Yung had sole decision-making authority for investment decisions of the ‘94 Trust. (Trial Tr. 2727:2-2728:19 (T. Rodgers Test.)).

CREDIBILITY OF THE WITNESSES:

The court finds that Yung and associates brought income into the United States from his CFC's on a routine basis. Yung and his associates looked for ways to accelerate this process but vetted possible means of doing so with a close concern for the risks involved, as evidenced by the decision not to participate in other tax strategies presented to them. Yung and his associates maintained a very conservative risk level about income tax reporting as evidenced by the IRS complimenting the consistent approach to paying taxes. The court finds the Yungs' testimony to be consistent with this approach to tax reporting and, therefore, to be credible.

The court finds from all of the testimony that the Leveraged Distribution 301 was a major product and undertaking for Grant Thornton. Its inception came on the heels of a product (GUAM) that was attacked by the IRS before it went to sale and caused reputational concern to the firm and its associates. The evidence indicates everyone who participated was on high alert regarding this product. As a result, while this court certainly understands the fading of memory, the failure of some of the Grant Thornton's witnesses to recall anything about their participation in the research and development of this product is disingenuous and not credible.

The following fact-finding is based on the court's determination of the credibility of each witness and the witnesses' over-all testimony especially as it relates to the important facts or turning points.

NOTE: This case is fraught with underlying business and personality tensions. The record in this case includes a plethora of documentation including many e-mail chains. It is the proverbial onion with many layers and this court, while having viewed and reviewed the record as a whole, has cited herein only the evidence that was most relevant to the making of the determinations contained in this finding of fact, conclusions of law and judgment.

THE PRODUCT

1. Grant Thornton developed a strategy designed to make certain types of distributions of monies with a minimum of tax consequences which it then marketed to clients, including Yung. As it was described in an internal Grant Thornton document dated August 1, 2000, (PX22):

> Description:
>
> The objective of the Leveraged 301 Distributions tax product is to structure distributions in order to permanently avoid taxability to shareholders. Either closely-held C corporations or S corporations can distribute assets subject to liabilities (―leveraged distributions") and provide this benefit to shareholders. …
>
> Please note that the Leveraged 301 Distributions product is a Level I tax-consulting product. …
>
> We currently believe that the Leveraged 301 tax product does not require the maintenance of investor lists under Reg. 1.6112-1T. However, for internal purposes we request that all practice offices maintain a list of clients and non-clients approached with this idea, regardless of whether or not the idea is ever implemented. …
>
> Background:
>
> *In General*
>
> Generally, shareholders must include distributions of property made from corporate earnings & profits in gross income as dividends under IRC §301(c)(1). However, §301(b)(2)(B) reduces the amount of the distribution by any liability to which the distributed property is subject. Therefore, a distribution of property fully subject to a liability would not be a taxable distribution because the amount of the distribution would be fully reduced by the amount of the corresponding debt. Shareholders of S corporations are also required to apply §301 to distributions received by them. By applying this idea to them, they can also avoid the recognition of income or the reduction in their stock basis.
>
> Later, the shareholder should not have a deemed dividend when the corporation subsequently pays the debt. §301(b)(3) states that the fair market value of a distribution shall be determined as of the date of the distribution. For purposes of determining dividend treatment, the amount is measured only once, at the time of the original distribution.
>
> Further, since the corporation is the primary obligor on the debt, any payments it makes satisfy its own obligation. Even if such payments result in an indirect benefit to the shareholders, the benefit is not taxes as a constructive distribution.
>
> Further, pursuant to §301(d), the basis in the property received by the shareholder will be the fair market value of the property at the date of the distribution *unreduced* by the liability to which it is subject. Therefore, the shareholder is taxed only on appreciation subsequent to the distribution.
>
> …
>
> *Other Risks and Exposure*
>
> The IRS may assert various judicial doctrines against the strategy. Further, the IRS may assert arguments it used against the BOSS transaction in Notice 99-59 and against the ―subject to" language of former IRC §357. The IRS may also argue that either the

> shareholders were never at risk for the debt or that they were the primary obligors on the debt. Finally, the IRS might import to IRC §301 the new definition of an assumed liability under IRC §357 under its regulatory power.
>
> …
>
> Product Deliverable:
>
> The deliverable includes an analysis of the proposed transaction specific to the taxpayer‘s situation. An accompanying opinion letter with a ―more likely than not" conclusion should preclude taxpayer penalties if ever assessed.

(all emphasis in original).

2. The product was introduced to the local practice offices of Grant Thornton by Horak on a tax products conference call on June 21, 2000, (PX20), in which this example was provided:

> STEP 1: Company could distribute cash, but instead purchases Treasury bonds (on margin) and distributes the securities. The margin debt is retained by the corporation.
> STEP 2: Company uses the cash to later pay off the margin debt.
> STEP 3: Bonds mature and shareholder receives cash equal to the face value of the bonds.

3. As it was tailored for use by Yung, the Lev301 involved moving money from the Cayman Islands into the United States by distributing profits of the CFC‘s to the shareholders (Yung, Mrs. Yung and the '94 Trust) as fully encumbered securities, thus in theory avoiding any tax consequences to the shareholders. The Grant Thornton plan for Yung involved the two CFC‘s buying some $30 million worth of two year Treasury Notes and borrowing an equivalent or greater amount of money with the T-notes as security for that debt so that they would have a zero net value on the books, then transferring them to the shareholders (Yung and the Trust) in the United States, and the CFC‘s paying off the debt six months to a year later with their cash and other securities on hand. Yung decided to go ahead with this strategy after the meetings with Grant Thornton.

REGULATIONS AND ENVIRONMENT

I. *THE TAX PRODUCT ENVIRONMENT*

1. During the 1990's accounting firms began developing and marketing generic tax products designed to generate significant tax savings for their clients. (PX 1263; Zink Dep. 16:2-17, Aug. 26, 2011). In 1999 Grant Thornton made a decision to join the trend and begin developing and marketing its own tax products. (PX 461; PX 1263; Trial Tr. 2932:21-2933:12 (Stutman Test.)).

2. The Firm's NTO (National Tax Office) became the product development "think tank." (Keith Dep., Vol. 1, 74:4-13). The NTO had the dual responsibility of both creating new tax products and vetting the products it created. (Trial Tr. 3057:25-3059:11 (Jorgensen Test.)). The delivery arm for the NTO's tax products was the FTPG, (Federal Tax Planning Group) headed by Carlson. (Trial Tr. 2903:14-2903:18 (Stutman Test.)).

3. In early 2000 Grant Thornton began to develop a product referred to as a leveraged distribution strategy for moving clients' offshore money into the United States with minimal tax consequences. Grant Thornton's entrance into the generic tax products market coincided with the U.S. Treasury Department ("Treasury") crackdown on products it perceived as abusive tax shelters. (Stutman Dep. 203:21-205:23, Nov. 10, 2011 (Vol. 1)).

II. *INTERNAL REVENUE CODE §301* – see Appendix "I"

4. IRC §301 addresses the tax treatment of distribution of property from a corporation to a shareholder. This is the section of the code used by Grant Thornton as the linchpin for the development of its leveraged distribution product. IRC §301(b)(2)(B) provides that, instead of using straight fair market value as the taxable amount distributed, "[t]he amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by the amount

of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution" so that only the net value is subject to tax.

III. *THE BOSS NOTICE (NOTICE 99-59)* – Appendix "D"

5. In December of 1999, six months before Grant Thornton's first developmental Think Tank meeting regarding the Lev301, the IRS issued Notice 99-59 (―BOSS Notice"). (PX 13). The BOSS Notice described a tax product called the Bond and Option Sales Strategy (―BOSS") being sold to clients by accounting firms, most notably by Price, Waterhouse, Cooper (―PWC"). (PX 25). The BOSS transaction, as described in the notice, involved a series of steps designed to create an artificial tax loss. (PX 13). The Notice described by example one typical arrangement as involving the following steps:

- Taxpayers, acting through a partnership, contribute cash to a foreign corporation (―FC") set up solely to effectuate the transaction. In exchange for its cash contribution, the partnership receives the common stock of the FC. Another party contributes additional capital to the FC in exchange for the preferred stock of the FC.
- The FC borrows money from a bank and grants the bank a security interest in securities acquired by the FC. The securities have a value equal to or greater than the amount of the bank debt.
- FC then distributes the encumbered securities to the partnership, which has the effect of reducing the value of the FC's common stock (held by the partnership) to zero or a minimal amount. The FC has sufficient other assets to pay off the debt and it is the understanding of the parties that the FC will repay the debt with the other assets.
- The partnership is then treated as having disposed of the common stock, creating a tax loss equal to the ―excess of the partnership's original basis in the stock . . . over the fair market value of the common stock after the distribution of securities (zero)."
- FC, typically in a later tax year, pays off the bank debt from its other assets, leaving the securities unencumbered in the hands of the taxpayers.

(PX 16).

6. The argument put forth by the taxpayers, as described in the BOSS Notice, was that no taxable income resulted from the distribution of the encumbered securities by the FC to the partnership under §301 of the Internal Revenue Code (―IRC"). The rationale given for the result

was that because the securities were distributed ―subject to" the bank debt, the value of the securities was reduced by the amount of the bank debt. And since the bank debt was equal in value to the securities, the value of the securities under IRC §301 was zero for tax purposes. Taxpayers further argued that no constructive dividend resulted from the FC's repayment of the debt in the subsequent tax year. (PX 13).

7. The BOSS Notice warned that the tax loss claimed in the BOSS transaction was not allowable for federal income tax purposes, and that ―the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under §6662, the return preparer penalty under §6694, the promoter penalty under §6700, and the aiding and abetting penalty under §6701." (PX 13). (All section references are to the IRC.)

IV. *NEW TAX SHELTER DISCLOSURE AND REPORTING REQUIREMENTS*

8. By early 2000 the climate surrounding tax shelters was notably harsh, with Congress and the IRS focusing on eliminating their abuse. (*See* Stutman Dep. 204:4 – 19, Nov. 10, 2011, *and* PX 17). On February 28, 2000, the Treasury issued a series of regulations targeting the promotion of, and participation in, abusive and potentially abusive tax shelters (―February 2000 Tax Shelter Regulations"). (PX 14). The regulations were announced in T.D. 8875, T.D. 8876, T.D. 8877. (PX 14).

9. **THE LISTED TRANSACTION NOTICE – Appendix "E"**: Notice 2000-15, also released on February 28th, introduced the term ―listed transaction." (PX 15). Listed transactions are transactions the Treasury or IRS identified in written guidance or regulations as unlawful tax avoidance schemes. (PX 15). This included transactions that were the same as or substantially similar to Notice 99-59, 1999-52 I.R.B. 761, BOSS transactions. (PX 15; see §III above).

10. **THE LIST MAINTENANCE REQUIREMENT**: T.D. 8875, 26 CFR 301.6112-1T, ―Requirements to Maintain List of Investors in Potentially Abusive Tax Shelters", released

February 28, 2000, imposed an obligation on “any person who organizes or sells any interest in a potentially abusive tax shelter” to maintain a list “identifying each person who was sold an interest in such shelter.” A “potentially abusive tax shelter” was defined as “a transaction for which a significant purpose of the structure of the transaction is the avoidance or evasion of Federal income tax.” The regulation required promoters maintaining a list pursuant to the regulation to “make the list available for inspection upon request by the Secretary of the Treasury.” (PX 14, p.761). Thus a transaction that comes within the “List Maintenance Requirement” is not necessarily a “Listed Transaction.” These two types of transactions may overlap but are each subject to a variation of disclosure and tax-return reporting requirements.

11. **THE TAX SHELTER REGISTRATION REQUIREMENT**: T.D. 8876, 27 CFR 301.6111-2T, “Corporate Tax Shelter Registration”, also released February 28, 2000, imposed an obligation on “organizers and promoters” of corporate tax shelters meeting certain requirements, which are referred to as listed transactions, to register such tax shelter with the Treasury. (PX 14, p. 753).

12. **THE REPORTABLE TRANSACTION OBLIGATION**: T.D. 8877, 26 CFR 1.6011-4T, “Tax Shelter Disclosure Statements”, also released February 28, 2000, imposed an obligation on corporate taxpayers filing U.S. income tax returns to disclose participation in “reportable transactions” by filing a statement with their tax returns. A reportable transaction was defined, in part, as “any transaction that is the same as or substantially similar to any of the specified types of tax avoidance transactions that the IRS has identified by published guidance as a listed transaction for purposes of §6011 and that is expected to reduce the taxpayer‘s Federal income tax liability by more than $1 million in any single taxable year or by a total of more than $2 million for any combination of taxable years.” (PX 14, p747).

V. *LEE SHEPPARD’S “BOSSY” TAX SHELTER ARTICLE*

13. On April 14, 2000, Lee Sheppard, a well-known and respected commentator on federal income tax issues, published an article in Tax Notes entitled *Corporate Tax Shelters: More Plain Brown Wrappers* (“Sheppard Article”). (*See, e.g.*, Trial Tr. 2905:12-23 (Stutman Test.) *and* Trial Tr. 3070:11-19 (Jorgensen Test.)). In her article, under the heading “Bossy,” she described a

variant of the BOSS product being marketed by Arthur Andersen. The Arthur Andersen “Bossy” transaction, as described by Sheppard, involved the following steps:

- A corporation borrows to buy a Treasury note that has a term of three to five years.
- The corporation would then distribute the Treasury note to its shareholders subject to the bank debt, who would hold the note and collect the principal at maturity.
- After the distribution, but before the note matures, the corporation would pay off the bank debt.

(PX 17).

14. Sheppard explained that the taxpayers in the Bossy transaction took the position that the value of the distributed Treasury note was reduced by the bank debt to which it was subject under IRC §301(b)(2)(B). Sheppard predicted that the Bossy product would be a “further impetus to the government to exercise its new §357 regulatory power” and that the government “could retroactively import to §301 the new definition of an assumed liability under the amended §357 to §301(b)” to combat the shelter. (PX 17). (See Appendix “J”, §357). All of the Grant Thornton NTO and FTPG were aware of and discussed this article.

VI. *THE SON OF BOSS NOTICE (NOTICE 2000-44)* – Appendix “F”

15. On August 11, 2000, the IRS issued modifications to the February 28th tax shelter regulations and also issued Notice 2000-44 which addressed another type of transaction, a derivative of BOSS, and declared that arrangements which purport to give taxpayers an artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those interests will not be recognized as bona fide losses reflecting actual economic consequences and therefore are not allowable as deductions and may also be disallowed under other provisions of the IRC. The Notice also provided that such arrangements are listed transactions and are subject to tax shelter registration and list maintenance requirements.

VII. *JUDICIAL DOCTRINES*

16. There are several doctrines from case law which were considered as to their application, if any, to the various transactions that comprise the Lev301 strategy.

17. The first of these is the Business Purpose Doctrine, which in essence is a requirement that a transaction be entered into for a valid business purpose and not merely to avoid taxes. It was determined that clients would have to show a valid business purpose to successfully utilize the strategy.

18. The Sham Transaction Doctrine requires that there be economic substance to the transactions for them to receive favorable tax treatment.

19. A third doctrine is the Step Transaction Doctrine, the basic idea of which is that the tax results of a series of steps in certain transactions should be determined based on the overall transaction; the key question becomes under what circumstances two or more transactions will be integrated for tax purposes and several tests are used to determine this issue.

20. Grant Thornton concluded that these doctrines would not invalidate the suggested tax treatment of the leveraged distribution transactions.

THE TIMELINE

I. *GRANT THORNTON BEGINS THE DEVELOPMENT OF THE LEVERAGED 301 DISTRIBUTION TAX PRODUCT*

A. The Think Tank - May through June 2000

1. No one associated with Grant Thornton, even those intimately involved in the process who testified to the court, has stepped forward and taken credit for the idea and creation of Lev301. The submitted paper trail of this product begins on May 16, 2000, at a Think Tank meeting attended by Stutman, Jorgensen, Bell, Burnett, Wittmer, and Keith. (PX 18; PX 25). At that meeting development of the product/solution was deemed a ―high priority item" and an

alert was issued to local practice offices to garner interest in the product. (PX 18). Jorgensen viewed this product as addressing opportunities in the market place and a way to add value to clients. He testified the meeting minutes suggest the product was undergoing research; he deflected the claim that he was the originator or responsible party for this idea/product. This product/solution subsequently came to be referred to within Grant Thornton as the Leveraged §301 Distributions tax product, or Lev301. (PX 22). The minutes reflect the participants knew that private companies might be sensitive to disclosure requirements and thus application should be limited to public companies. (PX 18, page 11 §d).

2. Keith, the most junior member of the NTO at that time, was assigned to conduct the tax law research and draft the "2-page write-up" that would be disseminated to members of the firm. (Keith Dep. 198:13-19; PX 18).

3. On June 12, 2000, Jorgensen e-mailed Keith instructing him to research two legal issues relating to the February 28, 2000, Tax Shelter Regulations. First, he asked him to research the meaning of "participation" as used in §1.6011-4T to determine whether a distributing corporation in a Lev301 would be required to disclose the transaction, even though its receiving shareholders would be claiming the tax benefit from the transaction. Secondly he directed him to research whether Grant Thornton would be required to maintain a promoter list for the Lev301. (PX 19). Research on these two issues was to ensure salability of the product.

4. While Jorgensen testified he doesn't remember this e-mail, it references Notice 2000-15, and supports finding: (1) he was the originator of the product; (2) he knew that a disclosure requirement would be a deterrent to sales of the product; and, (3) he recognized there were substantial similarities between the Lev301 and the BOSS transaction and that these last two

issues would subject the Lev301 to the February 2000 Tax Shelter Regulations and thus diminish its salability. (PX 19; PX 837).

5. The Think Tank met again on June 27, 2000, with Stutman, Jorgensen, Bell, Ziegelbauer, Burnett, Keith, Shin, Becker, and Wagner present. The minutes reflect that the participants were contemplating having a D.C. law firm review and provide a legal opinion on the Lev301 strategy. (PX1458/GT 1555).

6. These minutes allude to a draft opinion that was available for review. The testimony and evidence indicate that a draft opinion was not complete or available on that date. The only draft opinion that may have been available in this time frame is PX 24. Jorgensen testified PX 24 could have been his and/or Keith's work. This draft: (1) does not require the Client to represent that the borrowing documents are either recourse or nonrecourse, just that the Company not the Shareholder is the primary obligor on the debt; and (2) indicates that Grant Thornton must document and maintain certain information and make it available to the IRS if requested, however it does not call this a ―list" or reference the IRS regulations requiring list maintenance.

B. Grant Thornton officially introduces Lev301 tax product to the Firm

7. Lev301, along with two other new tax products, was introduced to the firm as a ―Level 1 Product" during a conference call on June 21, 2000, a little over two months after the Sheppard Article was published, and well after Notice 99-59 was issued. Grant Thornton also introduced, during the June 21 conference call, the Client Solutions Matrix (―Client Matrix"), an intra-firm website on which descriptions of tax products approved for sale by the NTO were posted. (PX 20).

8. The steps of the Lev301 described in the PowerPoint presentation for the call were substantively identical to those of the ―Bossy" product described in the Sheppard Article. (PX

20; Trial Tr. 4036:24-4038:2, 4040:2-25 (E. Yale Test.); J. Michel Dep. 171:12-173:3, Feb. 13, 2012 (Vol. 3)).

9. As a Level 1 Product, the Lev301 was assigned a –Product Champion” who was required to: (1) be involved in all sales of the product; (2) sign-off on all client engagement letters; and (3) conduct a final review and sign-off on all final opinion letters issued by Grant Thornton in support of the product. Jorgensen, as the Lev301‘s developer, was initially appointed to this role. (PX 20).

10. The objective of the Lev301, stated by Grant Thornton in the PowerPoint, was to –[s]tructure distributions to avoid taxability.” (PX 20). In addition to characterizing the Lev301 as a tax avoidance strategy, Grant Thornton identified a number of risks and exposures associated with use of the product, including:

- –§357(c) and legislative regulations thereunder”;
- –IRS Notice 99-59 (BOSS transaction)”;
- –Corporate Tax Shelter Regulations/IRS Notice 2000-15”;
- –Business purpose doctrine”;
- –Economic substance doctrine”;
- –Sham transaction doctrine”; and
- –Retroactivity of Congressional action.”

(PX 20).

11. Immediately following the product‘s introduction, J. Michel, who was a tax partner in the Cincinnati office at the time, began pitching the product to his clients. J. Michel communicated to others within Grant Thornton that the product had a –short shelf life,” and that all concerned had to react to opportunities quickly to ensure a successful sale. (PX 1023).

II. *GRANT THORNTON'S SALE OF THE LEV301 TO THE YUNGS AND THE '94 TRUST*

A. Relationship between Grant Thornton and Yung

12. Grant Thornton first began providing tax advisory services to Yung and his business entities in 1996. (PX 1265).

13. T. Mitchel, CSC's secretary/treasurer, was responsible for overseeing Yung's relationship with Grant Thornton, and acted on his behalf. (Trial Tr. 604:19-605:8 (T. Mitchel Test.); Trial Tr. 215:14-19 (W. Yung Test.)). T. Mitchel reported to Marquet, CSC's Chief Financial Officer who also communicated and oversaw Grant Thornton's relationship with Yung. (Trial Tr. 215:14-19 (W. Yung Test.)). As the secretary/treasurer of CSC, he relied on others to provide tax-related services before Grant Thornton was hired to provide such services. (*Id*. at 610:22-611:23). T. Mitchel began working with J. Michel through an introduction from Seraphino, who was also a financial advisor with Grant Thornton.

14. Between 1996 and 1999, Grant Thornton provided a range of tax-related services to Yung and his business entities without incident. *(Id*. at 616:8-12; PX 1265). J. Michel was at the Columbia Sussex building, the hub of the Yung business enterprises, on a continual basis. T. Mitchel and J. Michel attended seminars together. Additionally and significantly, on July 31, 2000, Grant Thornton submitted a proposal to acquire more of Yung's business, which included marketing Grant Thornton's gaming expertise to Yung in an attempt to provide consulting for CSC's casino operations. (PX 826). Grant Thornton and Yung had a comfortable and trusting business relationship with one another.

B. The Cayman Islands money

15. During the mid-90s, Yung acquired three hotels located in the Cayman Islands. Yung, along with the '94 Trust, owned these properties through two Cayman Island corporations:

Wytec Ltd. (―Wytec”) and Casuarina Cayman Holdings Ltd. (―Casuarina”) (collectively ―Cayman Corporations”). (Trial Tr. 620:2-623:22 (T. Mitchel Test.)).

16. As of 2000, Wytec was owned by Yung and two Grantor Retained Annuity Trusts (―GRATs”) of which the Yungs were beneficiaries. (*Id.*; PX 659). Yung and Martha are the successors in interest to the two GRATs, which no longer exist. (Trial Tr. 622:2-13 (T. Mitchel Test.)).

17. Casuarina, as of 2000, was owned by Yung and the ‘94 Trust. (PX 661).

18. Because both Wytec and Casuarina were organized under the laws of the Cayman Islands, both were considered Controlled Foreign Corporation (―CFCs”) for federal income tax purposes. (Trial Tr. 203:21-207:7 (W. Yung Test.); Trial Tr. 620:2-623:22 (T. Mitchel Test.)). Yung held all of voting stock in both companies, and served as the Chairman of the Board of Directors for both companies. (Trial Tr. 203:21-207:7 (W. Yung Test.)). Yung therefore had complete control over the activities of both companies. (*Id.*).

19. Through their hotel operations, the Cayman Corporations accumulated substantial cash, which the two companies held offshore in the Cayman Islands (―Cayman Cash”). Because of the federal income tax consequences of a distribution by the Cayman Corporations to their U.S. shareholders, distributions were only made by the Cayman Corporations when they could be made in a tax efficient manner. (Trial Tr. 206:18-207:11 (W. Yung Test.)). Because of the tax consequences of a transfer to the U.S., Yung‘s son Joe, a CSC executive, regularly travelled to the Caribbean, Central America and South America seeking acquisition opportunities. (Trial Tr. 2651:23-2654:2 (Joe Yung Test.); (Trial Tr. 3693:6-25 (J. Michel Test.)). J. Michel even assisted Yung in acquiring a hotel in Canada with funds held by the Cayman Corporations. (J. Michel Dep. 171:24-173:3, Oct. 28, 2011 (Vol. 1)). Neither Cayman company was legally obligated to

make distributions to its shareholders, allowing the profits to accumulate with no U.S. income tax consequences. (*See, e.g.*, Trial Tr. 624:12-14 (T. Mitchel Test.)).

C. Sara Williams joins CSC as tax director

20. Williams worked with J. Michel at Grant Thornton and reviewed the tax returns for CSC and its subsidiaries. As a result she established a good working relationship with T. Mitchel and CSC.

21. In 1999, CSC offered Williams a position and, because she wanted to change her work schedule, she accepted and became its tax director. (Williams Dep. Vol. 1, 25:21-26:5). At the time of her hire, Williams was a tax manager in the Cincinnati office of Grant Thornton working under J. Michel, and was familiar with CSC's tax needs. (Trial Tr. 613:24-614:17 (T. Mitchel Test.)).

22. Through her position as tax director, Williams became aware of the Cayman Cash. (Trial Tr. 3448:6-3448:20 (Williams Test.)). She was also aware of Yung's practice of moving the money out of the Cayman Islands only when it could be accomplished in a tax-efficient manner. (Trial Tr. 3491:2-3492:9 (Williams Test.)).

23. As CSC's tax director, Williams was regularly approached by competitors of Grant Thornton wishing to obtain CSC's business. Williams made these other accounting firms aware of the Cayman Cash. In one instance she allowed KPMG to present two proposals for transferring the wealth to the United States. (Trial Tr. 3448:21-3450:13 (Williams Test.)). The KPMG proposal was rejected. Significantly, T. Mitchel rejected those proposals because they appeared to be too risky. (Trial Tr. 626:6-626:14 (T. Mitchel Test.)). Williams was aware of the proposals and of the reasons for the rejection thereof.

24. Williams left CSC in December of 1999, again because of work schedule issues, and returned to Grant Thornton in Cincinnati. Shortly after returning to Grant Thornton, Williams discussed the Cayman Cash and the proposals made by Grant Thornton's competitors with J. Michel. (Williams Dep. Vol. 1, 41:20-41:24 & 43:22-45:19).

III. *JUNE AND JULY 2000*

A. **John Michel approaches Yung with the Lev301**

25. Aware of Yung's desire to find a tax efficient means of transferring the Cayman Cash to the United States, J. Michel approached T. Mitchel with the Lev301 shortly after its introduction to the Firm on June 21, 2000. (Trial Tr. 624:15-627:4 (T. Mitchel Test.)).

26. On July 5, 2000, ("July 5th Meeting") T. Mitchel met with J. Michel and Jorgensen at the offices of CSC in Fort Mitchell, Kentucky. (*Id*. at 806:23-807:17). A brief overview of the transaction's requirements was presented to T. Mitchel, who agreed to arrange a presentation to Yung. (*Id*. at 627:1-24, 628:6-8). Neither Jorgensen nor J. Michel disclosed to T. Mitchel that Lev301 was substantially similar to BOSS, a transaction the IRS had identified as an abusive tax shelter, (*Id*.; PX 837) and that the recently issued February 2000 Tax Shelter Regulations imposed disclosure and listing requirements on corporate participants in such transactions. (*See* Trial Tr. 633:17-637:9 (T. Mitchel Test.)). T. Mitchel was also not told about the Sheppard Article which characterized Andersen's equivalent "Bossy" product as a "BOSS variant" and noted that the Treasury had regulatory power to retroactively make such transactions unlawful, and which predicted that it would do so. (*See id.*). Grant Thornton believed that there was a 90% chance that the IRS would disallow the tax benefits of the Lev301 on audit. (*See id.*). This belief was not disclosed to T. Mitchel at any point. (*See id.*).

27. The likelihood that the IRS would view the Lev301 as an unlawful abusive tax shelter was a present risk that would have impacted T. Mitchel's decision to allow Jorgensen and J. Michel to present Lev301 to Yung. (*See id.* at 636:24-637:9; PX 1313). Jorgensen and J. Michel chose not to disclose this risk to T. Mitchel to induce him into moving forward with the sales process. (PX 1023). Had the risk been disclosed at the July 5th Meeting, T. Mitchel (as he had done with the prior proposals) would have terminated discussions about the Lev301 at that point. (Trial Tr. 653:17-654:12 (T. Mitchel Test.)).

28. Unaware of the substantial risk that the IRS would view Lev301 as an unlawful BOSS-like tax shelter, T. Mitchel set up a second meeting for J. Michel and Jorgensen to present Lev301 to Yung and the CFO of CSC at that time, Marquet. (Trial Tr. 627:8-628:8 & 635:4-635:12 (T. Mitchel Test.)).

B. July Lev301 Development

29. The ―Think Tank" with Stutman, Jorgensen, Shin, Voll, Keith, Burnett, Carlson, Kuck, Murphy, Hendon, Wittmer, and Wagner present met on July 11, 2000. The minutes note that research on Lev301 issues was substantially complete. It was anticipated that in two weeks the opinion letter would be written and reviewed. The group continued to consider a technical review of the opinion letter by an outside law firm. (PX 1457).

30. J. Michel in an e-mail dated July 14, 2000, approximately nine days after the idea was presented to T. Mitchel, updated and expressed concerns to higher level partners Carlson and Horak about Lev301. His indicated concern that Jorgensen had taken on too much and this product needed to have a fast delivery for the client. He stated, ―We all sense that this product has a short shelf life." Horak forwarded this e-mail to Carlson on July 15, 2000, a Saturday, urging him to visit clients about the product so that the program doesn't implode. (PX 1023).

31. T. Mitchel contacted J. Michel on July 18, 2000, thirteen days after the first meeting, indicating that Yung was interested and a meeting should be scheduled. J. Michel was at CSC corporate headquarters the next day, July 19, 2000, to discuss tax issues and indicated to Carlson and Jorgenson that a phone conference might be acceptable. (PX 1049). In fact J. Michel assisted with a filing before the United States Securities and Exchange Commission regarding the possible acquisition by CSC of Lodgian, Inc., on July 19, 2000. (GT 1571). (See Sections V(C) ¶102 and V(F), infra).

C. July 24, 2000 Lev301 sales presentation

32. Grant Thornton's second meeting with Yung on Lev301 occurred on July 24, 2000, (―July 24th Meeting"). (PX 1050). This was nineteen days after the initial presentation. Present for the meeting were Jorgensen, J. Michel, Yung, Joe Yung, Marquet, T. Mitchel, and Haught, who worked for Marquet on financing issues. (PX 1050; Trial Tr. 629:16-630:20 (T. Mitchel Test.)). Jorgensen led the presentation, while J. Michel diagramed the transaction's steps for the group. (*Id*. at 631:3-11: Trial Tr. 209:10-21 (W. Yung Test.)). T. Mitchel took two pages of handwritten notes during the meeting of all the topics raised by Jorgensen and J. Michel, a true and accurate copy of which was introduced as evidence. (PX 1050; Trial Tr. 629:16-23 (T. Mitchel Test.) Appendix A2).

33. J. Michel also took notes of this meeting. (GT 1523; Appendix A1). Plaintiff has objected to the introduction of these notes as Defendants did not make them available until two weeks before trial.

34. The court finds J. Michel's overall testimony lacks credibility and will take this into consideration in making factual determinations in this case. The court further recognizes that the late presentation of his notes raises additional credibility concerns regarding J. Michel

specifically and Grant Thornton in general. However, J. Michel‘s relationship with Yung, Joe Yung and T. Mitchel at the point of sale of this product and his integral involvement with Jorgensen, Voll, Keith and Gould from sale to IRS audit make his actions worthy of full scrutiny. The court overrules the Plaintiff‘s objection and admits these notes as evidence in this case.

35. Attached Appendix ―A" is the court‘s comparison of the T. Mitchel and J. Michel notes of this July 24th meeting. Taking into consideration the other notes of T. Mitchel in this case the court finds that the J. Michel notes are not credible. T. Mitchel‘s notes reflect the discussion of collateral early in the meeting while J. Michel‘s notes indicate this discussion occurred at the end of the meeting. T. Mitchel has ―business purpose" as the fourth item after lender participation while Michael has a discussion of all of the IRS and judicial doctrine concerns prior to a discussion of lender participation. Most importantly to the court for determination of credibility is the fact that ―listing" (and so list maintenance) and the requirement that the financing be ―nonrecourse" are not mentioned in either of these sets of notes.

36. Lev301 was presented to Yung by J. Michel and Jorgensen as a lawful tax strategy by which to transfer the Cayman Cash to the U.S. (PX 6; Trial Tr. 210:9-211:3 (W. Yung Test.); Trial Tr. 633:17-637:9 (T. Mitchel Test.)). Jorgensen and J. Michel understood that this advice would be relied upon by not only Yung on behalf of Wytec and Casuarina, but the shareholders of those companies as well, Yung, Mrs. Yung and the '94 Trust.

37. Jorgensen and J. Michel explained the need for a non-tax related ―business purpose" for utilizing the Lev301. (PX 1050; 637:10-638:4 (T. Mitchel Test.)). Yung was never told, however, that the non-tax business purpose had to be the primary motivation for utilizing the strategy to satisfy the business purpose requirement. (Trial Tr. 705:15-18 (T. Mitchel Test.); PX 1177; PX 1188). The requirement that the business purpose be motivating, and what that means

in a tax context, would have had an impact on Yung‘s decision as to whether to pursue the Lev301. (Trial Tr. 715:15-25 (T. Mitchel Test.)).

38. Jorgensen and J. Michel also represented to Yung and his advisors that with a Lev301 opinion letter from Grant Thornton, the ―worst case” scenario if he decided to utilize the Lev301 product was that the IRS, in an audit context, could require the shareholders of the Cayman Corporations to pay taxes and interest on the Lev301 distributions, but that the IRS could not assess penalties. (PX 1050; Trial Tr. 638:5-15 (T. Mitchel Test.); Trial Tr. 210:9-211:3 (W. Yung Test.)). The absence of penalty risk was material to Yung‘s decision to ultimately utilize the Lev301 strategy in December of 2000. (Trial Tr. 210:16-211:3, 446:18-447:10 (W. Yung Test.); Trial Tr. 656:6-657:8 (T. Mitchel Test.)). Jorgensen and J. Michel knew when they made the ―worst case” representation that it was untrue, and that because of the BOSS Notice, there was a 90% likelihood that the IRS would disallow the tax benefits and assess penalties against participants in the Lev301 regardless of whether the participant had an opinion letter from an accounting firm. (PX 828; PX 837; PX 1313; Trial Tr. 633:17-637:9 (T. Mitchel Test.)). Jorgensen and J. Michel also knew that the government was likely to retroactively change the law so as to foreclose Grant Thornton‘s interpretation of the ―subject to” language in §301, on which it was relying for its opinion. (PX 1023; PX 1150). Jorgensen and J. Michel made the ―worst case” representation to close the sale, knowing that disclosing the risk of penalty would have caused Yung to cease discussions with Grant Thornton about the Lev301. If Yung had understood that the risk of penalties stemmed from the fact that the Lev301 would be viewed by the IRS as an abusive tax shelter, and that the government was likely to invalidate Grant Thornton‘s legal argument in support of the strategy, Yung would not have engaged Grant Thornton for the Lev301. (Trial Tr. 210:9-211:3 (W. Yung Test.); Trial Tr. 633:17-637:9 (T.

Mitchel Test.)). Had Yung not engaged Grant Thornton for the Lev301, he would not have utilized the strategy in December of 2000.

39. Jorgensen and J. Michel also explained to the group that Grant Thornton had not done a Lev301 transaction yet. (PX 1050). T. Mitchel understood this to mean Grant Thornton was working on two or three other Lev301‘s but they had not closed. (T. Mitchel Test. vol. 1). Joe Yung told J. Michel and Jorgensen that Yung did not want to be Grant Thornton‘s ―guinea pig.” (Trial Tr. 2666:21-2669:4 (Joe Yung Test.)).

40. While the time frame is not clear, as J. Michel was at CSC headquarters often, at some point following the meeting, J. Michel told Joe Yung that, while he could not divulge the names of other Grant Thornton clients, he could disclose that a local jet-engine manufacturer and a local consumer products manufacturer had successfully used the Lev301 strategy to transfer foreign wealth to the U.S. (Trial Tr. 2666:21-2669:4, 2790:22-2791:13 (Joe Yung Test.): *see also* Trial Tr. 3788:23-3790:2 (J. Michel Test.)). Joe Yung understood the companies referenced by J. Michel to be General Electric (―GE”) and Proctor & Gamble (―P&G”). (Trial Tr. 2667:8-12 (Joe Yung Test.)). When J. Michel made this representation to Joe Yung, he had no knowledge as to whether GE and P&G had utilized a Lev301-like strategy. J. Michel‘s representation that GE and P&G had employed a Lev301-like strategy was made to allay the concerns of Joe Yung, as investment advisor to the Trust, (PX 651), and of his father, (Trial Tr. 286:12-286:23 (W. Yung Test.)), and those of the CSC group about being Grant Thornton‘s test subject. J. Michel‘s GE and P&G representation was intended to, and did in fact, impact Yung‘s decision to enter into the Lev301 engagement with Grant Thornton on behalf of the shareholders of the two Cayman Corporations. (Trial Tr. 2669:14-2670:5 (Joe Yung Test.)). Had J. Michel told Yung that he would in fact be the ―guinea pig” for the Lev301 product, he would not have entered into the

engagement, and thus, would not have utilized the strategy in December of 2000. (Trial Tr. 286:12-23 (W. Yung Test.); Trial Tr. 2669:22-2670:5 (Joe Yung Test.)).

D. Grant Thornton's failure to disclose Lev301 list maintenance requirement

41. Jorgensen and J. Michel did not disclose to Yung and his advisors at the July 24, 2000, meeting that Grant Thornton might be required to maintain a list of participants in the strategy because the Lev301 was a potentially abusive tax shelter within the meaning of the list maintenance regulations issued on February 28, 2000. (PX 1050; Trial Tr. 2966:3-5 (Joe Yung Test.); Trial Tr. 636:9-13 (T. Mitchel Test.); Trial Tr. 213:16-19 (W. Yung Test.)). When the July 24th meeting occurred, Grant Thornton had concluded that it was not required to maintain a list of individual participants in the Lev301 product because the regulations only applied to U.S. corporations. (PX 22). Because the Cayman Corporations were not U.S. corporations, and their shareholders were not U.S. corporations, Jorgensen and J. Michel saw no need to disclose the list maintenance requirement since it would not apply to them at that time.

42. The ―Think Tank" minutes of July 25, 2000, indicate that Stutman, Jorgensen, Ziegelbauer, Shin, Voll, Keith, Burnett, Carlson, Hendon, Wittmer, Wagner and Brezak were present and again discussed the ―Distribution of Leveraged Property". Jorgensen presented the agenda item which included: (a) In process of contacting law firm to review (Jorgensen Voll); (b) Working on preferred banker (possibly Banc One – Ziegelbauer & Jorgensen); (c) Opinion letter in process of being drafted – should be ready for review by the next think tank meeting (3 weeks); and, (d) Intranet write-up to be posted before next meeting (Keith).

43. It is significant that the day after the meeting with the Yung group, the opinion had not yet been written, and review by an independent law firm was being considered.

44. On July 27, 2000, Bryan Keith completed his Think Tank assignment for the company intranet. He e-mailed a copy to Jorgensen with a ―cc" copy to Burnett. This internet write-up is titled ―Tax Consulting Product-Level I, Lev301s (Leveraged §301 Distributions)" and appears throughout the trial with various exhibit designations; for the purpose of this finding it is designated as PX 21. This memorandum is consistent with the meeting with the Yungs on July 24, 2000, as it concludes that a list does not need to be maintained pursuant to Reg 1.6112-IT. It does however request that a list of clients and non-clients approached be maintained which contradicts this conclusion.

45. Most significantly, Keith, in a very concise paragraph on Page 2, #3, stated the basis for Grant Thornton's opinion: ―Even though the shareholder is neither taxed in the year of the distribution nor in the year of debt payment by the corporation, several court cases uphold that an unambiguous statute should be read and applied literally despite a taxpayer windfall." He further indicated that the IRS may assert arguments it used against the BOSS transactions in NOTICE 99-59 and against the ―subject to" language of former IRC §357. Lastly he acknowledged that the IRS might import to IRC §301 the new definition of an assumed liability under IRC §357 under its regulatory power." This memorandum is important because it addresses the potential of the BOSS transaction analysis which the J. Michel notes do not mention; and, it uses the phrase ―assumed liability" regarding IRC §357 which is not noted in either the J. Michel or the T. Mitchel notes.

46. On July 31, 2000, Grant Thornton sent CSC a proposal for ―financial statement audits". (PX 826). This letter clearly demonstrates that Grant Thornton was aware of the CSC business plan and was sensitive to its involvement in the Gaming Industry. This, coupled with the

knowledge of Yung‘s tax loss strategy gained from review of the tax returns, should have required Grant Thornton to make full disclosure, in writing, of the tax risks.

IV. *AUGUST 2000 AND THE DRAFT LEV301 ENGAGEMENT LETTER WITH GRANT THORNTON*

A. The draft Lev301 engagement letter

47. On August 4, 2000, approximately 30 days after the first meeting with Yung, Jorgenson, Carlson and Horak developed a draft engagement letter.

48. On or about August 8, 2000, Jorgensen sent the executed engagement letter for Lev301 to Yung, as representative of the Cayman Corporations. (―Draft Engagement Letter"). (PX 23; GT 618; Trial Tr. 640:25-641:13). (This letter has been designated variously as GT 5, GT 618, GT 617, GT 4, as it was revised by both parties.) T. Mitchel, on Yung‘s behalf, thoroughly reviewed the letter. Because the letter did not contain a confirmation of Jorgensen and J. Michel‘s representation that Grant Thornton‘s opinion letter would preclude the imposition of penalties by the IRS, T. Mitchel asked J. Michel to add this representation to the letter. (*Id*. at 646:2-11, 656:16-657:8). The majority of the other revisions by both parties concerned the fee for the services. This letter did not contain any specific notices about listing or about the essentials of the representations required by the company.

49. August e-mails indicate that there were two other clients interested in the Lev301 product (PX 1247 & PX 1024) which is consistent with the testimony of T. Mitchel and Joe Yung that J. Michel had indicated that there were other clients interested but who had not yet closed the deal.

50. On August 11, 2000, the IRS issued modifications to the February 28th regulations and Notice 2000-44 (―Son of BOSS Notice"; PX 35; Appendix ―F"). Notice 2000-44 made the ―Son of BOSS" transaction, a derivative of the BOSS transaction, a ―listed transaction." (PX 25).

51. On August 13, 2000, Hendon sent an e-mail titled, ―Description of Anti-Tax Shelter Notice to Appear Friday" to Carlson, Jorgenson, and Burnett. This article contains a section called ―The Audit Lottery." At trial Grant Thornton attributed this phrase to T. Mitchel but obviously it was a phrase that was circulated through Grant Thornton. (*See also* §VII ¶234, *infra*).

52. On August 14, 2000, Carlson e-mailed Stutman and Jorgenson that he had read 99-59 and was worried by the IRS' disagreement that a leveraged distribution can create a high basis. (PX 1313). On August 15, 2000, Jorgensen replied directly to Carlson and stated that Lev301 was about taxation of a distribution not taxation of losses created from an artificial basis. He indicated further that leveraged distribution is just interpreting the law as to one transaction which is the distribution of a dividend and therefore not the same as the multiple transactions used in a BOSS transaction. Jorgensen admits the Lev301 creates an artificial basis in the hands of the shareholders that does not reflect economic reality and relies on the application of an unambiguous statute with its loopholes and the doctrine of ―judicial restraint" to support his thesis. (PX 828, GT 1403). This ―unambiguous statute" statement is the same premise relied upon by Keith in the July 27, 2000, memorandum.

53. Jorgensen in this August 15th memorandum also indicated the prior week of August 7 was the first time he had the opportunity to work with the section of the opinion entitled ―judicial restraint" This is consistent with J. Michel's and T. Mitchel's notes not mentioning ―constructive dividend," ―step transaction," ―sham transaction," all of which involve tax shelters and thus listing. This e-mail has attached to it a draft of the leveragedopinion.doc. (GT 1403).

54. David Burnett was also concerned on August 14th, and noted that the modifications to the Tax Shelter Regs must be carefully read. (PX 1315).

55. On August 18, 2000, three weeks after the ―Think Tank" meeting Jorgensen e-mailed Voll a copy of the Lev301 opinion letter for review. He warns the co-author: ―DO NOT SHARE THIS OPINION WITH ANYONE, INTERNALLY OR EXTERNALLY, AS WE ARE TRYING TO MAINTAIN CONTROL OVER ITS DISTRIBUTION. THE ATTACHED COPY SHOULD BE SHREDDED HERE ON MONDAY MORNING ONCE WE GIVE YOU THE MORE RECENT DRAFT." This e-mail along with the prior e-mail in this chain from Voll to Jorgensen, stating he was working on an opinion insurance memo not related to Lev301, indicates Voll was still being given background information on Lev301 and was not yet the primary opinion writer. (PX 835, PX 836, PX 1147).

56. On August 21, 2000, Jorgensen e-mailed the Lev301 opinion to Hendon, Carlson and Stutman with the same warning about publication and shredding. Jorgensen acknowledged that there were still some ―technical" additions required and advised that the ―technical" review by Voll would begin that day. (PX 836, PX 1147).

57. On August 21, 2000, ten days after the August 11th issuance of Notice 2000-44, modifications to the tax shelter regulations and the Son of Boss Notice, the Wall Street Journal (―WSJ") published an article about the BOSS transaction and PWC's decision to stop selling it. (PX 836; PX 837; PX 1320). In response to this article, the NTO removed Lev301 from the Client Matrix, which had the effect of stopping all sales of the product. (PX 1254; PX 1320).

58. On August 22, 2000, at 12:02 PM, Jorgensen sent an e-mail to Holmes, J Michel and Carlson and asked if in light of Notice 2000-44 and the WSJ article that the fees for the Lev301 opinions should be increased. Jorgensen stated the following as a potential approach:

> You may be aware of the publicity that distributions like this has [sic] received recently. The IRS issued within the last few weeks Notice 2000-44 and the Wall Street Journal on August 21st had an article detailing a strategy that included leveraged distribution as part of a multi-faceted transaction. In order for

> you to position yourself to avoid underpayment penalties, you need to rely in good faith on a third party opinion letter. With these recent developments, our opinion needs to be updated so that you can then rely on it in good faith. And, given the attention that is being generated in the marketplace, it will only be prudent to assume ideas such as ours to be on the IRS radar screen. To best position yourself as the taxpayer, we want you to have a discussion with our national expert in this area. If you are still willing to proceed given these developments, we will need to adjust our fees accordingly, but, given our prior commitment to you, we will give you a 50% discount from our standard pricing arrangement.

(PX 837, PX 1317). There is no evidence that these concerns were expressed to the Yungs.

59. Jorgensen called this strategy a ―win-win;" J. Michel commented it made sense to follow this approach and if it created a ―credibility crisis," they could go back to the original pricing. Carlson indicated it was inventive. (PX 837, PX 1317).

60. Less than 20 minutes later Jorgensen e-mailed Carlson, Stutman, Voll and Burnett indicating that they needed to decide if Lev301 ―si a go or not" in light of Notice 2000-44 and the WSJ article; he requested a meeting to discuss the firms' position on the leveraged distribution. This e-mail also indicates that Stutman and Voll should have been able to read through the opinion at least once by the meeting date of August 23. (PX 1316). There is no direct evidence regarding this meeting or any follow up.

61. T. Mitchel, after reading the WSJ article, contacted Jorgensen expressing concerns about the legality of the Lev301. On August 29, 2000, Jorgensen documented in an e-mail about CSC that he talked with T. Mitchel about sharing the risk in the event the final outcome was not successful, which included insurance, and about fees. He noted he changed the engagement letter payment because he understood CSC didn't want to pay for something that they had not seen fully written up. Jorgensen indicated they discussed the WSJ article and Notice 2000-44 and conveyed that there was no cause for concern. He expressed Grant Thornton's conclusion that the leveraged distribution was ―distinguishable" from BOSS. In reply Carlson indicated that the

insurance issue would take too long. (GT 1426/PX 1073). There is no evidence that Jorgensen or Carlson presented their internally expressed concerns to T. Mitchel.

62. Jorgensen did not disclose to T. Mitchel that list maintenance was required nor that they had suspended the sale of Lev301 in response to the same WSJ article. (PX1459). This information would have notified Yung and his advisors that the Lev301 had not been fully vetted. *(See* Trial Tr. 681:19-25, 682:10-19 (T. Mitchel Test.)).

63. On August 31, 2000, Keith e-mailed, (PX 25), a copy of the Lee Sheppard article published April 14th and Notice 2000-44 published on August 21st to Hurley, who was designated by Carlson to be the ―get it done" person for leveraged distribution and other ideas. (PX 1459).

64. On September 5, 2000, Keith sent a Tax Shelter Checklist and Flow-chart to VanBrauman, a Grant Thornton salesperson in another region. Keith warned him that the Grant Thornton documents did not include Notice 2000-44 or the recent modifications to the corporate tax shelter regulations. (PX 28A).

65. On September 5, 2000, J. Michel asked Jorgensen if CSC could share a copy of the ―engagement letter" with their legal counsel. He was worried about the confidentiality of the idea but acknowledged that he had a good relationship with the law firm. (PX 1248). The document attached to the J. Michel e-mail is a marked copy of a draft of the engagement letter which includes very little information about the proposed transaction. (PX 1248).

66. The September 5, 2000, ―Think Tank Minutes": (a) reveal that Voll had not completed review of the opinion; (b) reveal that review by an outside law firm which had been on the table since July 27th had not yet been resolved; and (c) began a discussion about the opinion not addressing state and local tax (―SALT") implications.

67. On or shortly after September 6, 2000, J. Michel sent a revised version of the Draft Engagement Letter to Yung, dated September 5, 2000 (―Final Engagement Letter"). (PX 28). The final version, in contrast to the draft, was addressed to Yung as representative of the shareholders of Wytec and Casuarina. (PX 23; PX 28).

68. Prior to sending the Final Engagement Letter, Jorgensen e-mailed J. Michel that Grant Thornton could not back-up its representation that its opinion letter would preclude the IRS from assessing penalties against Yung in the event he was audited with respect to the transaction because of the BOSS notices. (PX 829). Without this representation, however, Jorgensen and J. Michel knew that Yung would not go through with the Lev301. In his e-mail to J. Michel, Jorgensen suggested three alternatives to soften the removal of the guarantee language:

- ―Reliance by a taxpayer in good faith on our written tax opinion often avoids the successful imposition of penalties…";
- ―Reliance by a taxpayer in good faith on our written tax opinion is intended to preclude the imposition of penalties…"; and
- ―Our written tax opinion should preclude but without any guarantee the successful imposition of penalties…"

(PX 829).

69. The changes to the regulations and the Son of BOSS Notice caused Grant Thornton to conclude that individual investors in the Lev301 would have to be included on Grant Thornton‗s IRC §6112 promoter list for the Lev301. (PX 30; PX 42; PX 792). Stutman recognized that the list maintenance requirement would be material to a client‗s decision to enter into a Lev301 engagement, and advised J. Michel to disclose the list maintenance requirement to Yung in the engagement letter, or in a separate writing. (PX 792).

70. When J. Michel realized that disclosing the list maintenance requirement to Yung would kill his sale, he decided not to disclose the requirement, and argued that Grant Thornton should

make a ―business decision" to not maintain a list so that they (as a firm) would not need to disclose the requirement to potential Lev301 clients. (PX 30; PX 1025).

71. Grant Thornton's failure to disclose the list maintenance requirement to Yung prior to his signing of the engagement letter constitutes a gross deviation from the standard of care applicable to tax professionals practicing in Northern Kentucky. (Trial Tr. 2235:4-2236:11 (Fritz Test.)). Disclosing the list maintenance requirement would have informed Yung and his advisors that the Lev301 product was a potentially abusive tax shelter within the meaning of the February 28, 2000, Tax Shelter Regulations. (*See, e.g.*, Trial Tr. 286:7-11 (W. Yung Test.)). Yung, because of his casino business, was particularly sensitive to tax issues, (Trial Tr. 2127:8-2131:5 (I. Rose Test.)), and Grant Thornton should have known this. (PX 826). Grant Thornton also had substantial expertise in the area of gaming regulation, which required it to exercise additional care when advising Yung on tax matters. (PX 826).

72. Had Yung or any of his advisors been made aware of the ―list maintenance" requirement, they would not have entered into the Lev301 engagement with Grant Thornton. (PX 1206; Trial Tr. 636:9-637:9 (T. Mitchel Test.); Trial Tr. 210:9-211:3 (Yung Test.)). And had Yung not entered into the engagement, he would not have utilized the Lev301 strategy. (Trial Tr. 318:8-14 (Yung Test.)).

73. Jorgensen and J. Michel testified that the list maintenance requirement was verbally disclosed to T. Mitchel prior to the signing of the engagement letter. The court finds in light of the language of the e-mail correspondence and Carlson and Stutman's insistence on written notice, so no one played ―professional roulette," that this testimony of Jorgensen and J. Michel is not credible. (PX 879). Additionally, there was no evidence that anyone at CSC, including T. Mitchel, had knowledge of or had been informed of a list maintenance requirement. There is no

evidence that T. Mitchel did not disclose all information in his possession to the necessary people at CSC. Finally, listing could not have been communicated to Yung either at the July 5th or July 24th meetings as the consistent testimony, including Jorgensen‘s, is that listing wasn‘t a concern until August 21st.

74. At trial this final engagement letter also tainted Stutman‘s testimony that risks are not included in ―engagement letters” when his e-mail of September 6, clearly indicates that he wanted the list maintenance risk included. (PX 792).

B. The final Lev301 engagement letter

75. Knowing that T. Mitchel would not advise Yung to sign an engagement letter without a reaffirmation of the ―worst case” representation made at the July 24th Meeting, the language included in the Final Engagement Letter read: ―Our written tax opinion should preclude the successful imposition of penalties by the U.S. Internal Revenue Service against the shareholders or Companies.” (PX 28). T. Mitchel understood the language to be a reaffirmation of the ―worst case” representation, and advised Yung to execute the engagement letter on September 15, 2000. (Trial Tr. 646:2-11, 656:6-657:8 (T. Mitchel Test.)). Nothing in the language of the Final Engagement Letter would have, or was intended to, put T. Mitchel on notice that Grant Thornton‘s opinion would not limit the downside risk to ―taxes and interest,” as previously represented to them at the July 24 Meeting. (PX 28).

76. The fee for the engagement was negotiated to $900,000, 3% of the $30,000,000 in planned distributions. (PX 28). Pursuant to the terms of the engagement, the bulk of the $900,000 fee was not due until after Grant Thornton had delivered its post-transaction opinion letters. (PX 28; PX 1279). The Draft and Final Engagement Letter includes one sentence purporting to limit Grant Thornton‘s liability for ―any reason” to the amount of the fee. Neither

the Draft nor Final Engagement Letter contains the word “negligence” or “malpractice.” (PX 23; PX 28). T. Mitchel, when advising Yung to sign the Final Engagement Letter, did not interpret the “any reason” language to absolve Grant Thornton from its own negligence or malpractice. (643:13-645:25 (T. Mitchel Test.)). Recognizing that the “any reason” language was inadequate to put clients on notice that Grant Thornton was limiting its liability for professional malpractice, subsequent Lev301 engagement letters were issued by Grant Thornton with language explicitly describing the scope of Grant Thornton‘s liability. (PX 191; PX 465; PX 468; PX 1213).

77. The Final Engagement Letter also provided that Grant Thornton was obligated to determine prior to the Lev301 distributions that it could issue an opinion in support of the transactions. (PX 28). The following language created this contractual obligation:

> If, based on ***preliminary conclusions***, the Firm cannot express an opinion on the federal income tax matters specifically identified in this engagement letter; the Firm reserves the right to withdraw from this engagement.

(PX 28 (emphasis added)).

78. Pursuant to the process described, Grant Thornton was also obliged to provide Yung with its preliminary conclusions (not merely reach them) before advising Yung to proceed with the distributions. (PX 28; Trial Tr. 651:24-652:14 (T. Mitchel Test.)).

79. The Final Engagement Letter did not contain any disclosures regarding the risks stemming from Lev301‘s substantial similarity to BOSS, or that the IRS was likely to deem the Lev301 to be an abusive tax shelter. (PX 28). No document provided by Grant Thornton to Yung regarding Lev301 used the words “potentially abusive tax shelter,” or cited the regulation making the Lev301 subject to list maintenance. (PX 23; PX 28; PX 53; PX 628; PX 163; PX 164).

V. *SEPTEMBER 15, 2000 THROUGH DECEMBER 29, 2000*

A. Baker & McKenzie review Lev301 model opinion letter

80. By July 11, 2000, Voll had joined Grant Thornton as a corporate specialist in the NTO. (PX 1457). Voll was hired by Stutman to bring experience to the NTO in drafting opinion letters for corporate tax shelter transactions. (Voll Dep., Vol. 1, 145:1-146:11 & 147:9-147:16). By August 18th, shortly after joining the NTO, he was provided with a copy of Jorgensen‘s draft model opinion for the Lev301 to provide comments. (Voll Dep., Vol. 1, 150:11-22; PX 835, PX 836, PX 1147; see section IV(A)¶55, *supra*).

81. Jorgensen‘s e-mail of September 14th indicates he was still the primary author of the Lev301 opinion and Voll was providing technical review. (PX 31). The review by outside legal counsel, which had been considered since July, was at that point and at trial referred to by Jorgensen as a ―gut check.” However, that the outside legal review was just a ―gut check” is contradicted by Jorgensen‘s statement that, ―we shouldn‘t be actively marketing the product if the law firm says we are all wet.” Jorgensen‘s testimony at trial that the outside lawyers‘ opinion did not matter as it was just a fatal flaw review is not credible in light of the e-mail traffic and other documentation in evidence. Additionally, it is also apparent from this September e-mail that the draft opinion was not complete and had not been released. (PX 31; PX 1149).

82. The e-mails of September 13, 14, and 15 show the pressure on the NTO by Grant Thornton sales staff for the release of the Lev301 which had been previewed in June and promised to them by August 18th. This also supports the finding that an opinion was not yet complete at that time. (PX 1149, PX1319, PX 885, PX 1320, PX 1325).

83. Voll, a lawyer, believed the model opinion authored by Jorgensen and Keith was of low quality. (Voll Dep., Vol. 1, 151:4-152:11 & 155:4-156:16 & 162:15-163:21). After reading the

model opinion, he testified that he recommended that it be sent for outside legal review. (PX 27; PX 488; PX 885; PX 1254; PX 1320). The ―Think Tank" minutes acknowledge that this outside legal review was always an option.

84. On September 18th, Stutman indicated by e-mail that the Lev301 opinion would be finished by September 25th with review completed by outside counsel by September 27th. Voll responded that outside counsel had agreed to complete their review by September 29th, not the 27th. He further indicated that the review would be by two lawyers at approximately seven hours each. (PX 887).

85. Grant Thornton engaged Peter Connor, a tax partner in Baker & McKenzie's (―B&M") New York City office, to review the first draft (the Jorgensen draft) of the Lev301 Opinion Letter. (PX 32). The review was conducted by Connors and Peter Norton, both of whom were tax lawyers at B&M. (Connors Dep. 46:20-47:1), (PX 36). The opinion letter was forwarded to them on September 25th and is contained in PX 32. While this draft opinion is different from the final opinion rendered, both lawyers expressed serious concerns about the Lev301's ability to satisfy the various judicial doctrines. (PX 36; PX 37; PX 40; PX 451; PX 830).

B. Ongoing Internal Discussions

86. E-mails from September 18th through the 25th indicate that research on the Lev301 was ongoing and included: (a) privilege and registration, (b) international leveraged distributions, and (c) debt equity under 301(b)(2). (PX 1026, PX 1251, PX 1322).

87. The September 20th e-mails between Jorgensen and Voll memorialized a discussion of the debt equity issue that is major part of the current litigation. (PX 1322). Voll indicated the liability issue is the one that troubled him. He queried, ―Is the lien on the securities a liability from the point of view of the shareholders?" He stated that the ―question of risk to the

corporation and the shareholders is a thin thread which centers on economic substance and thus is one of the Achilles' heels of the opinion." This communication clearly indicates that he believed the strongest argument for validity of the product is that IRC §301 is clear and unqualified, or in other words unambiguous. (*See also* §VI(F) ¶201, *infra*).

88. Jorgensen responded that the **loan** was not in play as to its equity flavor and the **lien** represented a nonrecourse liability to the shareholders. He also agreed that the strongest argument was that the law is the law but adding more strength to the risk argument made sense.

89. Voll continued the discussion. He indicated that it became difficult to say that the parties themselves ever viewed the **step** of encumbering the securities as anything other than a transitory step – almost economically meaningless in context. He then rephrased his premises: ―Again, this liability issue I raise is narrow. It is whether a debt to buy marketable securities purchased for the purpose of distributing them to shareholders, which debt was otherwise fully supported by on hand cash of the debt, but which **debt** was **nonrecourse** and secured by the marketable securities, was the liability that Congress intended to include in §301(b)(2)."

90. The court finds that this is typical of the mutual misunderstanding between the primary opinion writers of the Lev301. They used different words to describe the borrowing instruments and therefore don't clarify the nature and structure of the debt. Thus the requirement that the Lev301 must have nonrecourse liability is never clearly defined or communicated within Grant Thornton. This failure to define loan vs. lien vs. liability also leads to confusion in determining whether the distribution of the Treasury notes is ―subject to" the lien and/or ―assumed by" the shareholders. This is a fatal confusion for the determination of the taxation of the distribution and, thus, the viability of the Lev301 product.

91. On September 26, 2000, Stutman and Keith issued a ―Lev301 – Tax Shelter Disclosure" memorandum. (PX 34). The memorandum addressed the taxpayer's obligation to report a Lev301 transaction in accordance with IRS Reg. §1.6011-4T for a CFC. The memorandum accepted as its first premise the Jorgensen/Voll determination that the Lev301 was not a BOSS or the ―same as or similar to" a BOSS under IRS 2000-15 or any other official notification and thus reporting would not be required as a ―listed transaction."

92. The memorandum then addressed the other issues that could give rise to a requirement that the transaction be reported. The determination of whether it is a reportable transaction requires a multi-step analysis of the transaction. The memorandum concluded that if there were two or more of the six characteristics outlined in Reg. §1.6011-4T(b)(3)(i)(A-F) then the transaction was required to be reported, and stated, ―*Assuming all issues below are successfully resolved*, only 1 of the following 6 characteristics is found in the proposed transaction." (emphasis added). The court summarizes this memorandum as follows:

- The memorandum clearly determined that one characteristic, that the anticipated fee was over $100,000, was found in the Lev301 transaction.

- Another characteristic is that the taxpayers have contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained. Even though the engagement letter of September 5, 2000, states at page 2, ―The Firm's maximum liability to the company and its shareholders arising for any reason relating to the Opinion shall be limited to the amount of the fees paid for the engagement," the memorandum concluded that the taxpayer did not have contractual protection against the possibility that part or all of the intended tax benefits from the transaction would not be sustained. This finding was advanced by Stutman and Keith in light of the underlined conclusion of their memorandum, ―Consequently, the firm should not collect contingent fees <u>nor agree to refund any portion of fees collected should intended tax benefits not be realized</u>." If the answer was ―yes, there is a potential refund" the memorandum should have concluded this was a reportable transaction.

- Two other characteristics are whether the transaction utilizes a foreign party to obtain favorable tax treatment and whether the taxpayer knows that a participant is in a different federal tax position, e.g. a foreign party. Crucially these questions were preliminarily answered as ―no," even though it was based on an interpretation that, even though the transaction involved a foreign entity, no benefits would be obtained that would not be available to a domestic entity; however, the memorandum notes that some commentators interpret this part of the regulation to mean “virtually every transaction involving a foreign entity would be a reportable transaction” (PX 34, emphasis in original). A “yes” to either of these questions would have required the transaction to be reported.

- The question of whether the taxpayer would participate in the transaction under conditions of confidentiality was answered “no” while noting that an “exclusivity agreement is considered to be a condition of confidentiality unless the promoter provides express written authorization for disclosure.

- Finally, the analysis of the characteristic of whether the transaction is expected to cause a book/tax in excess of $5 million was noted in the memorandum to be open in that “a definitive conclusion cannot currently be drawn on this matter with the available facts.”

93. The court finds that, at a minimum the information in this memorandum should have been given to the Yungs so they could have evaluated it, and at a maximum it should have classified this as a reportable transaction in which case the later determination not to report it on his tax return made by Yung based on J. Michel‘s insistence and Williams‘ tax preparation is an intentional misrepresentation.

94. On September 29, 2000, as late as 6:28 P.M., Carlson was asking about the response from the B&M law firm. (PX 1253, PX 830). He received his response from Jorgensen at 7:17 P.M. (PX 830). That e-mail indicates that B&M had a discomfort with the “business purpose/econ. substance/step transactions” judicial doctrines and that *ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998), cert. denied 535 U.S. 1017 (1999), (“ACM”) changed the landscape of tax law. Jorgensen stated, “I pushed them on the judicial doctrines, citing appellate case law in our favor but they discount such cases as being pre-ACM. … Bottom line is I don‘t think we could ever remove their concerns with judicial doctrines.” As a result, neither attorney was willing to opine that Grant Thornton had reached the “more likely than not” confidence level it was targeting. (PX 10; PX 40; PX 830).

95. Jorgensen‘s e-mail indicates that he and Voll believe the light is amber, and that they should all put on their ―creative hats” in furthering the business purpose of the transaction (both the purpose for the bank debt, and more specifically the purpose for distributing encumbered property). The court finds this decision to creatively stretch, invent or strengthen the ―business purpose” for CSC, which Grant Thornton expressed as a requirement at the July 5th meeting, is an acknowledgment by Grant Thornton that they did not have sufficient authority to author a ―more likely than not opinion” and that they would have to fabricate a CSC ―business purpose” to try to accomplish that goal. Additionally, this e-mail‘s use of the word ―both” confirms that Grant Thornton was aware that the Lev301 was a step transaction and not, in the words of Jorgensen in his August 15th e-mail to Carlson, ―one transaction which is the distribution of a dividend and therefore not the same as the multiple transactions used in a BOSS transaction.”

96. After months of pondering the necessity for new eyes in the form of outside legal counsel to review the premises of the product, and then paying for and receiving that legal advice and criticism (which was more than a ―gut check”) of the substance of the product along with a warning about the tax environment (similar to that of Lee Sheppard which was routinely in testimony from Grant Thornton witnesses) Grant Thornton ignored the legal advice and continued on its sales course of Lev301. The court does not find as credible the testimony that an international firm such as Grant Thornton would hire a renowned firm such as B&M for a mere legal ―gut check” unless their definition of gut check is a substantial review.

97. Voll continued to struggle with B&M‘s advice and fell back to his clear and ambiguous statutory construction argument with them in subsequent e-mails. In an October 3, 2000, e-mail, Connor from B&M stated he was not questioning the basic tenants of statutory construction but stating that the statute must be analyzed in the context of the case. (PX 36).

98. Neither the Firm's decision to send the product for outside legal review, nor the adverse feedback received from B&M, was disclosed to Yung. (Trial Tr. 218:25-219:7 (W. Yung Test.)). The adverse reaction of B&M would have impacted a reasonable individual's decision as to whether to proceed with the Lev301 distribution. Had Yung or any of his advisors been told about the adverse feedback from B&M, Yung would not have authorized the Lev301 distributions in December.

C. Pre-distribution preparation

99. On October 3, 2000, Jorgensen and J. Michel discussed with T. Mitchel obtaining the loans for the Lev301 transactions. (PX 1051). T. Mitchel took handwritten notes at that meeting, and a true and accurate copy of those notes was introduced into evidence. (PX 1051). Neither J. Michel nor Jorgensen disclosed that the product was reviewed by outside counsel or that it was no longer being sold to clients. (PX 41; PX 1051). ―Business purpose" was discussed and cited by T. Mitchel as working capital for future actions. This was no more substantial than as discussed prior to the outside law firm review. There was no discussion about the multiple steps necessary to complete this act as pointed out by the law firm. There was no discussion about the recourse/nonrecourse nature of the lien/loan/liability or about the continuing issues of ―list maintenance" and the IRC §1.6011-4T reporting requirement.

100. On October 4th, Voll sent Stutman a status memorandum which outlined his continued research on the Lev301 Opinion Letter and admitted they had not yet arrived at a conclusion. He acknowledged in the second paragraph that he could not conclude the majority of cases support the conclusion that as a matter of law a clear and unambiguous statute is controlling. He indicated in paragraph seven that he had argued that the statutory construction argument was better than 52% and was the basis, and thus the firewall, to support the ―more likely than not

opinion.” And while the other arguments may have been only 50% that would not keep them from issuing the opinion if they had this one 52% opinion.

101. In paragraph three Voll acknowledged that the business purpose required: (a) a purpose for borrowing from the bank and (b) a purpose for the distribution subject to a lien. His discussion in this memorandum leads to the conclusion Voll did not believe that the current research would support a “more likely than not” standard. (PX 37). Voll reiterated his concerns in an undated memorandum to Stutman in which he stated the “more likely than not” opinion “is hovering around 50%, that using the rules of statutory construction [sic] the leveraged distribution (without qualification of business purpose, etc.) will survive court challenge.” (G047521, PX 10). This memo further advised Stutman that Connor suggested using a lower standard and Voll “think[s] we can make that threshold using at least the statutory construction argument.” Voll also began using a median formula, not an element formula, to support the “more likely than not”, i.e. 50% & 52% = 51.5% as more likely than not. None of these concerns, including lowering the opinion standard, were discussed with the Yungs.

102. An October 10, 2000, Voll e-mail to Stutman, copied to Jorgensen, expresses surprise that the primary statutory construction argument is not at 60% or 70% but at 50%. Thus this argument wouldn‘t prevent a court from moving through to attack the “business purpose” argument. Voll advances a probability theory based on a high percentage (60%-70%) probability being combined with lesser (30%-40%) confidence levels to establish a percentage of over 50.1% to reach the level of “more likely than not.” It is clear from this e-mail that Voll was struggling with the viability of the Lev301 and Stutman and Jorgensen were well aware of that. Jorgensen thought from day one the “business purpose” was sufficient and in the prior October 3rd meeting with Yung, Jorgensen did not express any additional concerns with the substance of

the business purpose. (PX 114). The court notes this because it is Grant Thornton's position at trial that the Yungs misled them about their business purpose. J. Michel was well aware of Lodgian, and whether it would qualify as a legitimate business purpose, at this time. (See Sections III(B) ¶31, *supra*, and V(F) and VI(E), *infra*).

103. On October 19th, a Grant Thornton tax advisor e-mailed Carlson, with a copy to Horak, and expressed his concern with the speed of new tax products. He was concerned that the Lev301 is the same product PWC got in trouble using, and informed Carlson that several “very good technical partners” were concerned about the apparent lack of consideration for “economic substance” and the “step transaction” doctrines. Horak responded by e-mail that a technical review by a reputable law firm was done and the product had received the thumbs up. (PX 1254; see ¶97). Horak was either lying to his partner when he said a law-firm did a technical review or confirming it was more than a “gut check” review; and he was lying to his partners when he indicated that the product received a “thumbs up.” This lie was passed on to the client and acted as a comfort to, and fraud upon, both the client and the sales force.

104. The October 20th drafts of the Tax Consulting Product - Level I for the Client Matrix included a warning that the Lev301 may require maintenance of an investors list under Reg. 1-6112-IT, which meant this issue was still not resolved. This document also explained the product in a way that contained clear steps: Step One in the transaction required two actions, and therefore clearly resembles a step transaction. (PX 42, PX 43), (See Regulations & Environment §VI, Judicial Doctrines, ¶18, supra; see also Experts, Hamersley, infra).

105. On November 2nd, J. Michel sent T. Mitchel and Marquet an e-mail outlining the steps of the Lev301. (PX 626). These instructions did not specify the nature of the lien/loan/liability, only that the corporation is the obligor and the shareholders cannot personally guarantee the

debt. Shortly thereafter, J. Michel (on Yung's behalf) approached PNC Bank to obtain financing for the distributions. (PX 889).

106. In November Voll, with the assistance of Keith and Shin, was still researching the statutory construction premise to achieve a "more likely than not" confidence level. (PX 45, PX 452). Voll instructed them in a November 13th e-mail to be less argumentative, as if the memo is trying to support the leveraged distribution product, and make more boldface statements a little more academically. (PX 1155).

107. In early December J. Michel e-mailed Stutman about his concern with the Lev301 commitment deadline for CSC. He reported that transaction specifics and documents were forwarded to Jorgensen and Voll, and Jorgensen had commented on the CSC loan documents. He wrote that they had a November 30th delivery date for the opinion letter and that Jorgensen had passed the final write-up to Voll.

108. On December 6, 2000, Hurley e-mailed J. Michel with Jorgensen's comments about the CSC bank loan. (PX 1308). The court finds that the e-mail conveys the impression that Jorgensen had thoroughly read and understood the language and the impact of the loan documents. It did not mention whether the lien/loan/ liability was required to be recourse or nonrecourse. On December 8th, Voll teleconferenced with PNC regarding the documents. On December 12th, Voll researched regarding the security interest. (PX 8, billing statement). The court finds that Jorgensen and Voll understood the language and the impact of these loan documents.

109. By e-mail on December 12th Voll sent his revised "opinion" to Jorgensen. The court recognizes this as Voll's "in the cave" version of the opinion. (PX 1542). This draft is significantly changed from the version that was reviewed by B&M. (GT1543). In fact in an

April 23, 2001, e-mail to Stutman, Voll stated, “there is hardly any similarity between the draft I was given and the current opinion.” (PX 1286).

110. On December 9th Stutman e-mailed Jorgensen, J. Michel and Carlson reminding them that although not a listed tax shelter, the Lev301 is still a “list maintenance” transaction. (PX 1329). On December 18th, J. Michel‘s e-mail to Voll, Jorgensen, Keith and Stutman acknowledges the transaction is subject to “list maintenance.” However, he pushed back on the requirement to “report” the transaction even though he agreed it had two of the six characteristics as outlined in the September 26, 2000, Tax Shelter Disclosure Memorandum. (PX 34, see ¶92; PX 1030). Yung was never informed of these two issues prior to the close of the transactions on December 28, 2000.

111. In mid-December, negotiations between Grant Thornton and PNC broke down. (PX 889). Wishing to close the transaction before the end of the year, (PX 1256), J. Michel and Haught met with Brian Bailey, a loan officer at Firstar Bank with whom CSC had done business in the past. (Trial Tr. 1251:5-1253:15 (B. Bailey Test.); PX 1032). During the meeting, J. Michel described the loan needed by the Cayman Corporations. (*Id.*).

112. On December 15th Horak and J. Michel anticipated trouble getting the “opinion letters” from Voll. (PX 1032, PX 1257).

113. Firstar approved the loans to the Cayman Corporations in late December. J. Michel was provided with a copy of the loan documents prior to their final approval. J. Michel assisted the Bank and the Yungs in the review of the documents and the completion of the transaction. (Trial Trans. 3681:5-3682:21 (J. Michel Test.); PX 855, PX 1485, GT173; Voll PX8, 12/15/00).

D. The December 28th Letter and Short-Form Opinion

114. Pursuant to the terms of the Final Engagement Letter, and prior to entering into the transaction, Marquet asked J. Michel to provide Yung with Grant Thornton‘s ―preliminary conclusions” as to whether it would be able to issue its opinion in support of the Lev301 strategy. (Trial Tr. 652:2-18, 840:24-841:5 (T. Mitchel Test.): ―If they told us they weren‘t going to issue the opinion, we wouldn‘t do the transaction[.]”)

115. A December 17th e-mail contained a discussion about the request of CSC for either a copy of the Tax Opinion Letter or a summary of the product and the impact that release and a request for confidentiality would have on the product. (PX 890). This e-mail confirms that CSC and its associates or attorneys had not been given a copy of the Tax Opinion Letter. J. Michel‘s December 18, 2000, e-mail clarified that it is the lender, not the client, who wanted the outline and advised against showing their hand. (PX 1030). This e-mail also contained J. Michel‘s countdown of the listing requirements of 1.6011-4T(b)(3)(i)(A) and he admitted there was a listing requirement and then made comments to diminish his admission with other statements.

116. This was two weeks before the final available closing date; over five months had passed since the promotion of the product to Yung and three months since the signing of the engagement letter. Grant Thornton still confirmed a list maintenance requirement for this transaction and that the NTO had read, understood and approved the loan documents and J. Michel was still working with Yung on other issues. (GT 168).

117. On the morning of December 28, 2000, Marquet informed J. Michel that the Firstar loans were scheduled for closing the following day. This confirms that Grant Thornton, this time through J. Michel, was reviewing the loan documents. J. Michel responded promising to send Marquet Grant Thornton‘s ―model opinion” by courier later that day, which would serve as

Grant Thornton's –preliminary conclusions" and would be customized for the fact pattern after the deal was consummated. Marquet responded with a request for the representation statements that were needed from Yung. (PX 1485, GT 173). The heading on this e-mail indicates it is about the Firstar transactions documents not the Grant Thornton opinion. Grant Thornton relies on this e-mail as corroboration that a draft of the opinion was sent. It is significant that this e-mail does not mention confidentiality, given Grant Thornton's overwhelming concern about confidentiality in the previous e-mails and the later e-mail to Yung's counsel.

118. On December 28th at 8:56 P.M., J Michel was still communicating about an attachment he has titled <<fact recital-prelim rep letter.doc>> with Katz, SMTP. GT 171 is a draft of the three-page December 28, 2000, opinion letter which contains –background" and –proposed transaction" sections. The –opinion" section was not included at that time.

119. The statement of facts necessary was not completed either until the evening of December 28th. (PX 52). Accordingly, Grant Thornton's short-form model opinion (–December 28th Letter") was not delivered to Marquet until the following morning. (PX 53). This is confirmed by the December 28th 9:09 P.M. e-mail from J. Michel to Voll, cc to Jorgensen, regarding two of the sections contained in the December 28th Letter. (PX 1475). The December 28th Letter has been identified as a –short-form opinion" which is common in the industry, by Hamersley, the Yung's expert. (Trial Tr. 1524:18-1525:17 (M. Hamersley Test.), see also Hamersley Opinion Six ¶48, *infra*). Grant Thornton, its agents and experts don't consider this December 28th Letter an –opinion" but testify calling it variously a –comfort letter," an –explanation," a –client relationship document," a –status update," and a –fore-shading." (Trial Tr. Jorgensen, Hamersley Opinion Six ¶48 and Yale ¶60, *infra*). The court will refer to it as –the December 28th Letter" or –a short-form opinion" or –the model opinion."

120. The December 28th Letter, authored by J. Michel, is addressed to Wytec and Casuarina, care of Marquet, and has the subject line: "Tax Opinion." (PX 53). The letter is comprised of an introductory paragraph, and three sections captioned "Background," "Proposed Transaction," and "Opinion." (PX 53). The letter is dated December 28, 2000, and is signed by J. Michel on behalf of Grant Thornton LLP. (PX 53).

121. In the introductory paragraph, J. Michel represented that Grant Thornton intended to issue its written tax opinion by January 15, 2001, and that the opinion would be in substantially the same form as the "draft/model opinion delivered to you on 12/28/00." (PX 53). The "draft/model opinion" referenced by J. Michel is the generic opinion contained in the "Opinion" section of the December 28th Letter. (PX 53). The court finds the draft "model opinion" was not contained in prior drafts of the December 28th Letter (PX 52) because of concerns about disseminating it electronically. (PX 94). The absence of the "model opinion" in prior drafts confirms that the "OPINION" section of the December 28th Letter was the model opinion "delivered" to Marquet on the morning of December 29th, and that no separate opinion was sent. (Trial Tr. 667:22-676:14 (T. Mitchel Test.)).

122. In the "Opinion" section Grant Thornton represented that it was of the Opinion that it was more likely than not that its conclusions would be upheld in litigation with the IRS. Underneath that statement is a numbered list of seven opinions, stated as follows:

> 1) The Company will recognize taxable income as a result of the leveraged distribution only to the extent that the fair market value of the assets distributed exceeds the Company's tax basis in such assets. For this purpose, the fair market value of the distributed assets is deemed to be at least equal to the amount of liabilities to which the distributed assets are subject.
>
> 2) The Company will reduce its earning and profits by the excess, if any, of the fair market value of the assets distributed over the amount of the liabilities to which the distributed assets are subject ("an excess distribution").
>
> 3) A shareholder will recognize taxable income only to the extent of an excess distribution. Furthermore, a shareholder will reduce his or her tax basis of

> the stock held in the Company as a result of the leveraged distribution only to the extent of an excess distribution.
>
> 4) A shareholder will have a tax basis in the assets distributed equal to the fair market value of such assets at the date of the distribution. Such tax basis will not be reduced by any liabilities to which the distributed assets are subject.
>
> 5) A shareholder will not be in constructive receipt of a distribution, e.g., a dividend, upon any later payment by the Company of the liabilities to which the distributed assets are subject.
>
> 6) Judicial doctrines will not override opinions expressed on the aforementioned issues.
>
> 7) A shareholder or the Company will not be subject to any tax penalties in relying in good faith upon the opinions expressed on the aforementioned issues.

(PX 53).

123. Grant Thornton, which included J. Michel, Jorgensen, Voll, and Stutman, knew that the Yung transactions, as well as others, were closing. The introductory paragraph of the December 28th Letter clearly assured Yung that he could rely on the representation that the firm would issue a post-transaction tax Opinion Letter containing the same seven opinions as those contained in the letter to complete the Lev301 transaction. (PX 53). Jorgensen in his testimony indicated that it would be conjecture as to whether Yung should rely on this December letter and said the draft model opinion should answer that question.

124. The Court finds that the December 6, 2000, Draft Model Opinion, the last form of which was introduced as GT 1543, was never copied to either Yung or Yung's counsel. The testimony was clear that without representations by Grant Thornton as to the viability of the transaction the Yung's would not have proceeded. The December 28th Letter was provided to the Yungs specifically to induce them to use the strategy and close the Lev301 transaction.

125. The December 28th Letter does not contain any disclosure of the list maintenance requirement or the risks stemming from the transaction's substantial similarity to BOSS. (PX 53). The Yungs were not told prior to closing of the ―list maintenance" requirements, the

reporting issues, or that Grant Thornton had not reached a ―more likely than not" confidence level for the issuance of this December 28th Letter.

E. Wytec and Casuarina carry out the first two steps of the Lev301 strategy

126. On December 29, 2000, in reliance on Grant Thornton‘s representations regarding the Lev301 and the December 28th Letter, Marquet executed the Firstar loan documents in the amount of $30,000,000 on behalf of Wytec and Casuarina, and $30,000,000 in Treasury Notes (―T-Notes") were purchased with the proceeds. Per the terms of the loan, the Cayman Corporations granted Firstar a security interest in the T-Notes, and they were placed in custodial accounts in the names of the two companies. Firstar had the right to proceed against either the T-Notes or the Cayman Corporations in the event of a default. (Krug Dep., Vol. 2, 26:1-28:1).

127. On the same day, meetings of the boards of both Cayman Corporations were held to declare a dividend of the encumbered securities, and the T-Notes were transferred from the accounts of the Cayman Corporations at Firstar to custodial accounts in the names of Yung, the GRATs, and the '94 Trust. (PX 163 at CS000685; PX 164 at CS000567).

128. Later the same day, Baker Bahamas — another Lev301 client — made a distribution to its shareholders using the Lev301 strategy pursuant to J. Michel‘s advice. (PX 1032; PX 1462).

129. Of the seven opinions listed in the December 28th Letter (¶122, supra), numbers 3, 4, 5, and 7 were material to Yung‘s decision to authorize the Lev301 distributions. (Trial Tr. 1431:1-1432:4 (M. Hamersley Test.); Trial Tr. 646:2-646:11 (T. Mitchel Test.)).

130. As of December 29, 2000, Grant Thornton‘s primary conclusion that no taxable income would result from the Lev301 distributions was based upon an interpretation of the ―subject to" language of §301(b)(2)(B) of the Internal Revenue Code, the constructive dividend doctrine, and the position that judicial doctrines could not override a textualist interpretation of a

Congressional statute. As to the IRC §301 argument, the crux was that the shareholders could reduce the value of the distributed T-Notes by the amount of the bank debt to which they were ―subject to" as collateral, even if the shareholders were not personally liable for the bank debt, so at the time of the distribution the tax value of the T-Notes would be $0, and no tax would therefore be payable by the receiving shareholders. (PX 24 at G026992-G027020).

131. Grant Thornton's argument that no constructive dividend would result from the distributing corporation's repayment of the bank debt was based on the shareholders not being personally liable for the bank debt. According to Grant Thornton, because the shareholders would not receive a benefit from the repayment of the debt, no constructive dividend would result. (PX 24 at G027020-G027039).

132. To overcome the application of judicial doctrines, Grant Thornton concluded that they could not be applied by a court to a Congressional statute that is ―clear on its face" (unambiguous) and that IRC §301 was such a statute. (PX 24 at G027040-G027053).

133. Grant Thornton's representation that it was ―of the opinion" that no tax consequences would result from the Lev301 transactions as of December 29, 2000, and that it would issue an opinion within three weeks confirming the same, was material to Yung's decision to enter into the transaction. (Trial Tr. 652:2-18, 840:24-841:5 (T. Mitchel Test.)). At the time Grant Thornton made this representation, Voll — who had taken over as the technical champion for the Lev301 — had not yet concluded that a more likely than not confidence level was possible. Had Grant Thornton informed Yung or his advisors that it had not yet reached a more likely than not confidence level for the product, he would not have authorized the transactions to occur. (Trial Tr. 646:21-647:21, 652:2-18, 677:3-678:1, 840:24-841:5 (T. Mitchel Test.)).

F. The Lodgian acquisition

134. At the same time that the Lev301 distributions were being made, Yung was in the process of acquiring Lodgian, Inc., a publically traded hospitality company. (G. T. 168, Trial Tr. 221:23-222:11 (W. Yung Test.)). Yung was not primarily motivated by that acquisition when he authorized the Lev301's, and no mention of Lodgian is made in the December 28th Letter in the "Background" or "Proposed Transaction" sections. (Trial Tr. 697:19-25, 705:15-25 (T. Mitchel Test.); Trial Tr. 221:9-222:15 (W. Yung Test.); PX 53). J. Michel was aware of and worked on audits for this acquisition; as a result, Grant Thornton was fully aware of this business transaction and would not have been mislead when they chose to use it to bolster Yung's "business purpose" to support the Lev301. Had Yung not gone forward with the Lev301 transaction on December 29th, he would not otherwise have transferred the Cayman Cash at that time. (Trial Tr. 219:8-219:12 & 221:23-222:15 (W. Yung Test.)).

VI. *JANUARY 2001: TREASURY ISSUES TEMPORARY AND PROPOSED REGULATIONS UNDER §301 OF THE I.R.C.*

135. On January 3, 2001, just five days after the Wytec and Casuarina Lev301 distributions, the Treasury issued temporary and proposed regulations §1.301-1T under §301 of the I.R.C. pursuant to the authority granted to it by Congress under §357(d) of the I.R.C. ("January 4th Regulations"). (PX 91). The regulations had an effective date of January 4, 2001, but were made retroactive to distributions made before the January 4th effective date that were "made as part of a transaction described in, or substantially similar to, the transaction in Notice 99-59 including transactions designed to reduce gain." (PX 91).

136. The Treasury Decision announcing the regulations, T.D. 8924, was explicit as to the purpose of the regulations and the transactions being targeted, providing:

> The Treasury and the IRS have determined that it is appropriate to apply the rules of section 357(d), relating to the manner in which a liability is treated as assumed, to distributions of property under section 301 of the Code. Section 301(b)(2)(A) provides that the amount of the distribution will be reduced if the transferee assumes a liability of the corporation. Section 301(b)(2)(B) provides that the amount of the distribution will be reduced if the transferee receives property subject to a liability. These two sections do not provide specific rules for determining the amount of liabilities assumed, as contained in section 357(d). The lack of specific rules has led to interpretations of existing law that fail to reflect the true economics of certain transactions. For reasons similar to those that motivated the enactment of 357(d), these interpretations are inappropriate for purposes of section 301. Notice 99-59, 1999-2 C.B. 761, illustrates one such case. In the transaction addressed in Notice 99-59, a corporation distributes property subject to a recourse liability, with the expectation that the distributee will take the position that it receives little or no net distribution, even though it is anticipated that the distributor will later satisfy its continuing primary liability on the debt.

(PX 91; Appendix “G”).

137. The effect of the regulations was to invalidate Grant Thornton‘s argument that a shareholder who received a distribution of T-Notes “subject to” a liability that was recourse to the distributing corporation could reduce the value of the T-Notes by the amount of the liability. (Trial Tr. 1445:23-1447:22 (Hamersley Test.)). The January 4th Regulations provided that “[f]or the purpose of §301, no reduction shall be made for the amount of any liability, unless the liability is assumed by the shareholder within the meaning of §357(d)(1) and (2).” (PX 91; see Appendix “J”). For recourse liabilities, IRC §357(d)(1)(A) states that “a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability.” (PX 91). Because the Lev301 was specifically structured so that the distributing company‘s shareholders would not be liable for the bank debt, application of the January 4th Regulations to the Wytec and Casuarina Lev301 distributions meant that no reduction could be made. (Trial Tr. 1445:23-1447:22 (Hamersley Test.)).

138. The January 4th Regulations mirrored the Sheppard Article prediction as to how the IRS would combat the ―Bossy" tax shelter. (PX 56; Trial Tr. 4036:24-4040:1 (Yale Test.)).

A. The Internal Discussions

139. By 9:44 A.M. on January 4, 2001, Bottiglieri, a tax partner in the New York office, recognized that the January 4th Regulations invalidated Grant Thornton‗s legal argument in support of the Lev301, wrote to Voll:

> Dick
> my quick read of new temp regs [sic] under 301, issued today, means leverage distribution plng [sic] is dead and perhaps retroactively!

(PX 1158 at G082130.002).

By 10:00 A.M., Keith, a co-developer of the Lev301 with Jorgensen, circulated the January 4th Regulations and a copy of the Sheppard Article to Jorgensen, J. Michel and Peter Hurley, the Lev301 product manager, writing:

> Here are the regs.
> In addition, I attached Lee Sheppard‗s article from several months ago describing 301 under the title ―bossy" and how the IRS might shut it down.

(PX 56; PX 57).

140. By 10:09 A.M. Horak was asking Stutman for confirmation and Stutman had already contacted Voll to begin an evaluation of the regulations. The tenor of this exchange uses ―Black Tuesday" analogies such as ―the window is open." (PX 1258). Sometime that day, the ―Think Tank" with Stutman, Burnett, Keith, Quimby, Carlson, Ziegelbauer, Jorgensen, Hendon, and Shin met and did not determine the ongoing viability of Lev301; they set a deadline for determination of January 31st. (PX 58).

141. By 11:31 A.M. Voll was responding to Bottiglieri arguing his statutory construction conclusion; however, he added that there was no consensus but in his opinion ―in fact patters [sic] of the first few paying clients, despite all of the above, may still fly even if we accept the

law as the IRS reads the operative rules." Bottiglieri's response was that it was still iffy to bring to a client. (PX 1158).

142. On January 5, 2001, at 8:03 A.M. Jorgensen e-mailed a suggested plan of assignments to address the issues raised by the published regulations. Again, Stutman, Keith, Carlson, Hurley, Voll, and Burnett are in the inner loop. Stutman confirmed his involvement by e-mail. (PX893 & PX1330). In this e-mail exchange Voll continued to champion his statutory construction theory as the answer to the regulations and Stutman completed a memo on these regulations and the Lev301 for Horak to distribute to the Grant Thornton professionals. (PX 894).

143. Several partners at Grant Thornton expressed similar sentiments to those at the NTO that the impact of the regulations is to kill the Lev301 strategy. (PX 1258; PX 1260; PX 1263).

144. On January 7, 2001, Jorgensen e-mailed a ―301 regulation" memo to Stutman, Voll, Burnett, Carlson, Horak, Hendon and J. Michel. (PX 60). This is a significant memorandum as it outlines his response to the new regulation and his prior position on the Lev301. All of his expressed positions are consistent with the first draft of the Lev301 Opinion Letter which was his work-product. He stated:

(1) That thoughts about the Lev301 should be kept to the working group, which includes. Stutman, Voll, Carlson, Keith, Burnett Horak, Hendon and J. Michel;

(2) That he was sure that all the issues have not yet surfaced;

(3) That now that the shareholder was to be treated as having ―assumed the liability for tax purposes" a later payment by the corporation, even though the corporations remained the only obligor for legal purposes, would probably be treated as a ―constructive dividend." (This is also the conclusion of plaintiff's expert, Hamersley, regarding the Lev301 both before and after the January 4, 2001, regulations – see section on Experts, Hamersley, *infra*). He stated this

conclusion will kill the product. He asked if the group could ―think of some more than reasonable exceptions so a tax return position can be taken that a deemed dividend doesn't result," which supported a conclusion by Jorgensen that pre-January 4th transactions must be retrofitted. He asked how strong an argument they could construct that, despite an assumption by the shareholder, the corporation remains the only obligor for the indebtedness for legal purposes. [This supports a conclusion by Jorgensen that Voll's statutory construction argument is either flawed or has not reached a ―more likely than not" confidence level. It also supports a finding that Jorgensen knew that the loan documents, which were already signed, were recourse to the corporations and thus the transactions result in a taxable event to the shareholder.]

(4) That the regulations might be invalid which he admits is extremely difficult to sustain. [The court notes that this is Voll's initial analysis. At trial the defendant's expert, Yale, opines this argument is not addressed in the Final Opinion because if Grant Thornton had argued invalidity they would have been required to advise the Yungs to file a Form 8275-R with the IRS. See section on Experts, Yale, *infra*].

(5) That if the regulations are valid and result in a constructive dividend then the two very significant engagements in which distribution occurred are impacted and the issue of the retroactive effect of the regulations must be addressed. He called this the worst case scenario. He argued that Notice 99-59 characterized creation of artificial loss as an abuse, and it was only with the publication of the January 4th regulation that reduction in ―gain" was characterized as an abuse, thus the distributions prior to January 4th are not the same or similar to the Notice 99-59 BOSS Transactions.

(6) Finally, he argued that even if the regulations were valid and retroactive, they were only one part of the analysis and thus the ―more likely than not" standard should be readdressed.

He relies on the Voll statutory construction of IRC §301 argument, which he has already diminished earlier in the memo.

(7) Lastly, he expressed a caveat that the requirement for disclosure to the IRS raised the risk that the clients would not want to purchase the Lev301 product. This last concern by Jorgensen stresses that Grant Thornton and its agents were aware that “list maintenance” was moving into IRS disclosure at the minimum for post-January 4th transactions. [The court finds that Grant Thornton should have told Yung that this was a “list maintenance” transaction and could be subject to disclosure.]

This memorandum (PX 60) was shared with J. Michel who continued to promote the Lev301 product.

145. At 12:10 P.M. on January 8th, in response to this memorandum, Voll e-mailed that the constructive dividend has been handled in the opinion based on the current law and it concludes that “nothing about shareholders accepting of the security subject to a nonrecourse obligation, as a matter of law, has made the shareholder assume the obligation.” He stated that the primary obligor of the bank loan remains the corporation. Voll concludes that, “Our opinion is still valid on constructive dividends – even if the language is put into the as of yet unwritten regulations.” (PX 1259).

146. At 4:59 P.M. on January 8th Voll again addressed the Jorgensen memorandum in an e-mail to Jorgensen copied to Stutman, Keith, Burnett, and Carlson. (PX 65). He emphasized, “The point is the regulations present no more of a problem with this issue than we had acknowledged in the opinion existed before they were published.” Voll does not remind this strategic group that the constructive dividend argument in the opinion is not at a “more likely than not” confidence level. (See section on Experts, Yale, *infra*.) Citing *Enoch v. Commissioner of Internal Revenue,*

57 T.C.781 (1972), Voll stressed that unless the shareholder is “personally liable on the debt paid by the corporation there is no constructive dividend.” He then stated that the Journal of Corporate Taxation article, “Section 357(d) – Old Can, New Worms,” does not apply because this transaction is a nonrecourse note. He then argued a position that is held by Grant Thornton‘s expert Yale that the regulation does not change the nature or the obligation to the shareholders which is nonrecourse. (See section on Experts, Yale, ¶¶76-86, infra.) However, he pointed out that the *Enoch* case found that it was local law that interpreted the loan agreements (not just the note) to determine if the obligation is recourse or nonrecourse. He then stated, “Of course, the client would be thoroughly advised of all of this recent development and our rationale in the opinion.” The court finds that while Voll understood the entire loan transaction to be nonrecourse, in both of the e-mails he uses a hybrid definition of nonrecourse meaning that the obligation may be recourse as to one party and nonrecourse as to another. The court finds this information was never conveyed to Yung.

B. Grant Thornton removes the Lev301 from the Client Solutions Matrix

147. On January 8, 2001, Horak e-mailed the Grant Thornton partners a “LEVERAGED DISTRIBUTION PRODUCT” memorandum. (PX 61). This announces the removal of Lev301 from the Client Matrix and ends the sale of the Lev301 product until further notice. Horak, who authored the removal memo, an assignment he received from Stutman, doesn‘t remember the memo but has no reason to believe the memo is incorrect. (Horak Test.). Jorgensen doesn‘t remember the memo despite the fact it was part of his strategy. (PX 1330). The court finds the faded memory of Jorgensen and Horak and others to lack credibility given the tension and drama and professional concerns that the January 4th memorandum created for this Grant Thornton product.

148. The January 8, 2001, notice, which was vetted by several partners before it was posted, states several inaccuracies or at the very least confusions based on the testimony of Jorgensen, Voll and Stutman. It states that: (1) the product –was subjected to a rigorous internal quality assurances process and included receiving comments from a major international law firm.” [The court finds this memo once again conveys to Grant Thornton partners that the outside legal review was favorable, which it was not.] and, (2) that the product has been pulled from the Client Matrix and that all clients and prospects that are currently considering this transaction should be notified of the regulations and that the impact is being evaluated. This suggests to the court that the local Grant Thornton professionals such as J. Michel would notify their clients that the product was not being sold and that concerns, including the listing and the disclosure issues, were being addressed. (PX 61).

149. Voll authored a memorandum regarding the loans on January 9, 2001, and on page 2 in a caveat indicated that if the bank put a blanket lien on the asset distributed and any other asset – including stream of earning – there is a problem with the concept. (PX 63). Obviously if Grant Thornton had again reviewed the loan documents as changed there would be an understanding that the lending institution could seek recourse beyond the asset in the Yungs transactions.

150. In response to the decision to remove the product, Horak received an e-mail from tax partner Stacy Rubsam suggesting that Grant Thornton stop selling tax products that lack –tax common sense.” (PX 1263).

151. Shin authored a memorandum on January 9, 2001, and on page 2 concluded that if a taxpayer challenges a regulation to avoid a penalty pursuant to Treasury regulation 1.6662-3(c) the position must be disclosed on Form 8275-R and the challenge must be in good faith. It is clear that upon J. Michels‘ advice and oversight there was no disclosure by the taxpayer.

152. On January 10, 2001, Voll continued his development of thought about the regulations. During his analysis he stated: “Incidentally, I think we all assume we know exactly what we mean when we talk loosely about recourse and nonrecourse, personal liability and such. I have a feeling that those terms have their own complexities under local state law – e.g. is there a limited assumption, partial assumption. Being precise might become important in any economic analysis???" (PX 65). Clearly the lack of clarity about the nature of the loan documents was starting to make an impact.

153. On January 10, 2001, at 4:42 P.M., J. Michel e-mailed Marquet and represented that he was “having trouble getting a draft opinion" from Voll," because the “master opinion [was] being revised to take into account the Jan 4, 2001, Treas Regs." (PX 64). The December 28, 2000, short-form opinion had promised a final opinion by January 15, 2001. (PX52).

154. J. Michel represented to Marquet that Grant Thornton was “of the opinion" that the January 4th Regulations did “not adversely affect" the Wytec and Casuarina Lev301 distributions because they were “finalized prior to the effective date" of the regulations. J. Michel also represents to Marquet that the Firm believed that its revised Lev301 master opinion would “indicate that such Regs may more favorably impact the favorable tax status of the 2000 year transaction." On the date of J. Michel's e-mail, Grant Thornton had not reached a conclusion as to whether the regulations were retroactive, nor whether they might “favorably impact" Grant Thornton's legal arguments. (Voll Dep. 836:7-21, Mar. 15, 2012 (Vol. 3); (PX 67; PX 69; PX 101; PX 522; PX 793; PX 832; PX 905; PX 1334). J. Michel did not disclose to Marquet that Grant Thornton was no longer selling the Lev301 in response to the January 4 Regulations. (PX 64). Significantly, this memo confirms that “a draft of the final opinion" had not been shared with the client or client's counsel Andy Berger. This e-mail supports the court's finding that the

testimony by J. Michel, Voll and Jorgensen is not credible on the issue of Yung having a draft of the model opinion prior to closing.

155. Voll is of the opinion that as of January 10th the two transactions could have been unwound without tax consequences. (R. Voll Dep. 288:14-290:24, Nov. 8, 2011 (Vol. 1); R. Voll Dep. 645:16-646:20, Mar. 15, 2012 (Vol. 3)). If Yung had been informed of Grant Thornton's decision to cease marketing of the Lev301 in response to the January 4th Regulations, he and his advisors would most likely have taken action to unwind the transaction to undo the tax consequences of the December Lev301 transactions. (Trial Tr. 682:10-19 (T. Mitchel Test.)). J. Michel's concealment of the Lev301's removal from the Client Matrix and the likelihood that the regulations were retroactive to the two transactions was intended to prevent Yung from taking action to unwind, which would have prevented Grant Thornton from receiving its $900,000 engagement fee. (PX 28; PX 1279). J. Michel admitted in a subsequent e-mail that he told Marquet that the January 4 Regulations did not impact the transactions to merely ―buy time with the client." (PX 831).

C. The Discussions Continue

156. The e-mail traffic and research at Grant Thornton's NTO concerning the Lev301 is extensive. Stutman indicated he wanted consensus from Voll and Jorgensen on the issues. To that end, in a January 12, 2001, e-mail regarding IRC §§301, 357 and the regulations, Voll asked Jorgensen if it was his opinion that tax treatment of the distribution would vary as either a dividend or capital contribution depending on the relationship between the corporation and shareholders and who is the transferor or transferee. (PX522). It is the court's understanding that the tax treatment is determined by IRC §357 when a shareholder is transferring to the corporation or IRC §351 when the corporation is transferring to the shareholder.

157. On January 15, 2001, Jorgensen, contrary to Voll and Stutman‘s request, opened the discussion to others, including J. Michel. Jorgensen also included Hendon, Carlson and Hurley. He advised them they were looking to determine if there was any ―wiggle room" in the regulations. (PX67). This e-mail then addresses Jorgensen‘s thoughts about the regulation‘s impact including his interpretation that either a constructive dividend or capital contribution results. (PX67).

158. On January 17, 2001, Shin e-mailed Voll and expressed his concern that Notice 99-59 includes transactions designed to reduce gain and the product seems to do just that and thus this triggers retroactive application to the Lev301. Voll responded the next day that ―gain" is usually the consequence of a capital transaction not a distribution of dividend, and was concerned about Shin‘s interpretation.

159. On January 19, 2001, an e-mail from Keith to Shin requests research on the nature of the liability itself, not just its relationship to the parties. Keith stated that the Lev301 strategy is a nonrecourse liability and BOSS was a recourse liability.

D. Grant Thornton concludes that the January 4th Regulations are retroactive to the Wytec and Casuarina Lev301 transactions

160. On January 23, 2001, J. Michel e-mailed Horak. This e-mail clearly reflects J. Michel‘s agitation regarding the lack of a written opinion for a $30 million decision. He stated that he bought time beyond January 15th with the Yungs based on a Grant Thornton decision that the effective date of the new regulations was not an issue. (PX 0831 & 1266). This e-mail is reflective of the overall anxiety and concern regarding Lev301 within Grant Thornton. The e-mail resulted in a meeting called by Stutman with Jorgensen and Voll.

161. There was no evidence presented at trial to substantiate that Grant Thornton had determined that the new regulations were not an issue. On or about January 23, 2001, Voll

communicated to Jorgensen, in a handwritten memorandum, his and Shin‘s conclusion that the January 4th Regulations are in fact retroactive to the December 29th distributions. (PX 536). Voll‘s conclusion that the January 4th Regulations are retroactive necessitated a conclusion that the Lev301 is ―substantially similar” to BOSS. (PX 536). Again, at this juncture, Grant Thornton should have advised the Yungs to unwind the transaction. (Trial Tr. 2264:10-2266:2 (Fritz Test.)). It is interesting to note that, despite these fatal concerns, Shin communicated with J. Michel on this date asking for more corporate representations regarding business purpose. (PX 71).

162. Two days later, Bottiglieri e-mailed Jorgensen and Voll an Ernst & Young (―E&Y”) Tax Alert dated January 23, 2001, which warns that Lev301-like transactions are fully taxable under the January 4th Regulations. (PX 1338). In fact the article describes the Lev301 without reference to the nature of the obligation as recourse or nonrecourse. Voll and Jorgensen, despite the conclusion that the January 4th Regulations were retroactive, simply ignored the E&Y Tax Alert because it was ―just an E&Y Tax Alert.” (PX 1338).

163. No one at Grant Thornton communicated to Yung or any of his advisors its determination that the January 4th Regulations applied to the December 29th distributions and that according to E&Y the distributions were fully taxable. (Trial Tr. 717:18-22, 682:10-19 (T. Mitchel Test.)).

164. There is a flurry of e-mails on January 23rd within the NTO about the completion of the Yung opinion letters. (PX 1268). That same day, which is three days after Voll determined that the January 4th Regulations were retroactive, Marquet e-mailed J. Michel asking him whether Wytec and Casuarina should pay off the Firstar bank loans to stop the interest expense since no opinion had been delivered, or whether Grant Thornton would pay the interest ―if the deal never

finalize[d] as planned.” (PX 1042). Marquet was not aware that Voll had concluded that the regulations were in fact retroactive to the Lev301 distributions made by Wytec and Casuarina.

E. Yung is given an incomplete draft opinion letter to placate his concerns about Grant Thornton's failure to deliver its opinions letters

165. On January 29, 2001, Voll e-mailed J. Michel a draft of the ―opinion”. In it he emphasized J. Michel was not authorized to share it with clients. He also stressed he was still researching for ways to strengthen Yung‘s ―business purpose” and requested more information on the Yung businesses. (PX 17).

166. Prior to February 2001, Grant Thornton had taken great pains to keep its model opinion letter secret because it feared that competitors or the IRS might become aware of it and ruin the strategy for them. (J. Michel Dep., Vol. 3 165:22-166:24; 167:5-19), (PX 1320). Even employees of Grant Thornton associated with the Lev301 were not permitted to see the model opinion letter. (P. Hurley Dep. 92:4-93:14, 93:23-94:8, Dec. 12, 2011; PX 1320).

167. E-mail traffic in the first week of February 2001 within the NTO indicates continued confusion about the development stages of the product; in fact, Voll stated he wasn‘t aware there was a product in September of 2000. (PX 1269, PX 902). On February 3rd Horak inquired of Jorgensen if the product was ―go or no go”. (PX 1272). This confusion caused Stutman on Feburary 4th, 2001, to scream in an e-mail ―WE NEED TO GET OUR ACT TOGETHER”. (PX 827 & PX 1270 & PX 903).

168. On February 5, 2001, Bulletin No 2001-6 was issued by the IRS. (Appendix ―G”). This bulletin outlined the changes to IRC §357 and its application to IRC §301. (PX 91). It is interesting to note on the same day the bulletin was published, and before a draft of the first full opinion letter was given to Yung, J. Michel pressed Voll not to over-emphasize ―business purpose” in discussions with Yung, confessing he doesn‘t know if they will sign the

representation they have already been given. (PX 1164). The court finds, despite J. Michel‘s testimony that this e-mail merely expressed his frustration with Voll, that this is a clear admission of Grant Thornton‘s failure to inform and disclose to their client Yung all the information necessary for him to make an informed decision.

169. J. Michel‘s concerns about overemphasis of ―business purpose" representations is conveyed in a Voll e-mail to Stutman in which Voll complained that J. Michel was told to get certain representations to complete the opinion and without discussion he drafted them in bullet points and sent them to the client. Voll indicated the representations weren‘t all that was needed and ―were not the appropriate representations we would write when we are trying to do it right." (Sic.) He further stated that J. Michel had not acknowledged or commented on the draft opinion sent to him on January 29th. (PX 1165). In this string of e-mails J. Michel admitted he did not read the draft and stated he had learned from Stutman several days before that there was a newer draft opinion. (PX 1166).

170. On February 6, 2001, at 1:00 in the afternoon, Jorgensen responded to Horak‘s question of whether it was a ―go or no go" that they were still waiting for a review of the IRC §301 regulations. (PX 1272).

171. Also on February 6th, at about 3:00, to prevent Yung from paying off the loans and terminating the Lev301 engagement, J. Michel sent Marquet and T. Mitchel, with a copy to Yung‘s attorneys, an incomplete draft of the Wytec opinion letter (―Draft Wytec Opinion Letter"). (PX 94; PX 628; PX 834 at 335). The Draft Wytec Opinion Letter was **the first full-length opinion** that Grant Thornton had provided to Yung. (Trial Tr. 675:8-676:14 (T. Mitchel Test.)); (PX 834; PX 836; PX 890; PX 1320).

172. In the transmittal e-mail accompanying the Draft Wytec Opinion Letter, J. Michel wrote, ―The opinion is missing verbage [sic] in noted areas. That verbage [sic] is being drafted as we ‗speak' but it will only serve to strengthen the opinion." (PX 94). J. Michel did not disclose or include a caveat that the Firm had not determined the effects of the January 4th Regulations, and that was the reason a discussion of the regulations was not included in the February 6, 2001, Draft Wytec Opinion Letter. (PX 94; PX 101; PX 1474). Furthermore, J. Michel failed to disclose the fact that the Lev301 was not being sold by the Firm at that point and Grant Thornton wasn't sure they had a product. (Trial Tr. 681:19-25, 682:10-19 (T. Mitchel Test.); PX 793; PX 92; PX 94; PX 1339).

173. The ―Think Tank" minutes of February 6, 2001, in which meeting J.Michel wasn't included, indicate the Leveraged 301 Product had not yet been determined to have ongoing viability. (PX 92). The e-mail of the Draft Wytec Opinion Letter was followed up by J. Michel with a phone message to Yung's attorney in which confidentiality is stressed, the fact that he is not supposed to share with counsel is stated, and the reason for delays is explained as being related to interpretations of the new regulations, which he cities as additional supporting authority. (PX 1414, GT 1320).

174. Horak made another inquiry of Jorgensen about the status of the product on February 9th. (PX 1274). The court finds that as of February 9, 2001, the product was still not completed as viable at a ―more likely than not" standard; Yung was in possession of an incomplete draft of the opinion; Yung had been asked to provide additional representations on business purpose without direction from J. Michel as to the reasons underlying the concern therefor. Some six months had passed since Grant Thornton had first introduced the Lev301 product.

175. The Draft Wytec Opinion Letter is 55 pages; it begins with an introductory paragraph and is divided into five parts. (PX 628). The five parts are titled ―OPINION," ―FACTS," ―REPRESENTATIONS," "ANALYSIS," and ―CONCLUSION." Following the ―CONCLUSION" section are two appendices, ―APPENDIX I" and ―APPENDIX II." (PX 628).

176. The ―OPINION" section contains a numbered list of six tax opinions regarding the Wytec Lev301 transaction. (PX 628). The six are consistent with opinions one through six in the December 28th Letter. (PX 826; PX 53). The Draft Wytec Opinion Letter does not contain an opinion like that of opinion number seven regarding penalties in the December 28th Letter, but it does not disclaim that representation either. (PX 628; PX 53).

177. T. Mitchel reviewed the ―OPINION", ―FACTS" and ―REPRESENTATIONS" sections of this draft to ensure accuracy. (Trial Tr. 706:8-707:15 (T. Mitchel Test.)). He reviewed only the first few pages of the ―ANAYLSIS" section because the technical tax law discussion was beyond his comprehension. (*Id*. at 707:16-25). He did not review the ―CONCLUSION" section or the appendices, and was not instructed to do so by J. Michel. (*Id*. at 708:1-11, 708:24-709:3; PX 94). T. Mitchel did not review the opinion with the intention of identifying risks relating to the transaction because he reasonably assumed that any material risks would have been disclosed to them by Grant Thornton, their tax expert, before Yung authorized the Lev301 distributions.

178. Through February the drafting continues on the Lev301 product, specifically the Yung opinions. (PX 100; PX 1167). The viability of the product had still not been finalized. (PX 1168; PX 1275; PX 905; PX832).

179. On February 19, 2001, in an e-mail to Stutman, Horak, Carlson, J. Michel and Hurley, Jorgensen concluded that there are no current regulations that provide for constructive dividend treatment, only an indication by the Treasury in the January regulations. He warned that

prospects should be told of the **material and significant risk** that the issued regulations would result in a constructive dividend to shareholders. He opined that for completed transactions they should consider a ―rescind and restore” strategy. He stated that in Yung‘s case, accelerating the bank debt retirement would assure completion of the Lev301 strategy before the issuance of the constructive dividend regulation which would be without a retroactive effect. (PX 1276). Voll responded to Jorgensen, ―We already tell the client that the law and the regulations can change at any moment. That covers us. … We advise the client of the regulatory activity. Beyond that — what we say about what could happen is conjecture. Will it get better or worse or stay the same.” (PX 101). At trial, Voll explained that this advisement to clients of possible regulatory change is in the opinion. (Voll Test.). Jorgensen‘s argument greatly concerned Horak who stated, ―it sounds like a matter of time before the regulations are issued.” (PX 1171). Jorgensen responded that it was probable that if the regulations were issued they would be immediate or have a retroactive effect. (PX 1280). The court finds that while J. Michel did inform Yung of the regulatory change he did not stress that it could change again at any moment without an exit strategy; J. Michel informed the Yungs that the situation was good and improved by the regulations, not that the regulation and its future interpretation would create material and significant risk. Yung closed the Lev301 transaction with the understanding that retirement of the bank debt was to be delayed; it was never disclosed to Yung that he might have to accelerate payment of the bank debt to save the transaction. Yung could have tried rescission of the transaction if he knew it was just a matter of time before the regulations were issued and that it was probable there would be a retroactive effect.

180. In a February 20th e-mail Stutman acknowledged to Horak that viability of Lev301 had not yet been determined as Jorgensen and Voll had not yet agreed on the ―constructive dividend" issue; he also acknowledged that undoing a Lev301 transaction might not be simple. (PX 1277).

181. Also on February 20th Voll agreed with Jorgensen to ―leave the product out there." This e-mail is critical of the fact that it appears Jorgensen wants to further inform clients of litigation risks. Voll stated, ―This transaction is unlikely to be easily caught on to by the IRS. (If it is the opinion should stop a penalty – so the client got what it paid for.)" (PX 1170).

182. On February 22, 2001, J. Michel advised T. Mitchel how to prepare the tax return on the Lev301 and states that ―They would want to review the tax forms." (PX 102). J. Michel also informed Horak and the Grant Thornton billing department that a payment on the product by Yung was due by February 26th with the remainder at the time of the bank debt retirement which could be in June or sooner in light of the threatened issuance of regulations. (PX 1279). On February 28, 2001, by e-mail, J. Michel, Voll, Jorgensen, Shin and Stutman were still holding discussions about whether there needed to be disclosure of the transaction on the Yungs' income tax filings. (PX 1341; PX 1172).

183. In March of 2001, Grant Thornton was still working on Lev301 engagements signed before the January 4th regulations, housekeeping on the Yung Lev301 opinions is occurring, and the Lev301 product is being prepared for reinstatement. (PX 1281; PX 1173; PX 104, PX 1282; PX 1445; PX 1283). J. Michel monitored Yung to assure that no disclosure of income due to this transaction appears on their tax returns, and discussions and editing continued around the representations that Yung was to make in order to fit his business purpose to the Lev301 product. (PX 467; PX 1052).

184. On March 5, 2001, Grant Thornton was working on the exhibits for the Yung opinions and working other Lev301 clients. (PX 104, PX 1173).

185. Also during March, J. Michel was being considered as the product champion.

186. On March 30, J. Michel e-mails Voll that he is asking for ―the opinion of counsel" in representations number nine and eleven, namely that the company is the sole and primary obligor and that the shareholders will never become primary obligors. Otherwise they were asking non-lawyers to make legal conclusions. (PX 1052). This e-mail acknowledges that J. Michel and Grant Thornton knew that Yung was not relying on legal counsel for a second opinion on Grant Thornton's expert opinion.

F. Grant Thornton recommences sales of the Lev301 and changes the product in response to adverse feedback from outside counsel.

187. In April 2001, Grant Thornton decided to start selling the Lev301 product again, despite the January 4th Regulations and the hostile regulatory environment. (PX 512; PX 1283; PX 1284). Grant Thornton continued to omit crucial details about the product's risks and the weaknesses of Grant Thornton's legal arguments. (PX 1344). J. Michel, who had now sold three engagements to his clients — Yung, Union Savings Bank, and Baker — was made the ―Product Champion" for the Lev301, replacing Jorgensen. (Trial Tr. 3624:8-3624:22 (J. Michel Test.); PX 1445).

188. On May 3, 2001, Voll e-mailed J. Michel, copied to Stutman, about coordination of the Lev301 product. (PX 111). It suggests that there is a lack of coordination but more importantly this e-mail expresses Voll's concern about strength of a ―business purpose" to assure the integrity of a ―more likely than not" opinion, and references Yung (Wytec) as having a weak business purpose that Grant Thornton used other devices to overcome. He expressed that it was difficult to make the result fit but that, while it was close, it was done. The court finds that this

concern was never expressed to Yung. Additionally, Jorgensen testified at trial that the client communicated the business purpose to him on July 5, 2000; that he understood that business purpose, he thought it was an adequate business purpose, and he didn‘t understand Voll‘s concern in this e-mail about the ―business purpose” being close. (Jorg. Test.). The court finds that this is a concrete example of the lack of communication and miscommunication within Grant Thornton that was grossly negligent. Additionally, Grant Thornton was reviewing Yung‘s tax returns and doing analysis for acquisitions, so it would be negligent of Grant Thornton not to have been an expert on the Yung‘s business and its purposes. The obvious conclusion is that Grant Thornton‘s Lev301 product was a tax avoidance strategy and they merely used ―business purpose” as a red herring for the client and the IRS.

189. On May 3rd Carlson weighed in and said he wanted to read the most recent opinion to better understand why the product still worked given the IRS attacks, as old leads for the product didn‘t understand how it was still viable. (PX 1449). He also contacted Stutman about the Voll e-mail and was concerned about the delivery of the product. (PX 1176). This further supports the court‘s finding of lack of communication and miscommunication about this product as Carlson didn‘t understand why it is viable but yet wanted to make sure it continued to sell.

190. On May 7, 2001, J. Michel issued a response e-mail to Voll which was a push-back on the ―business purpose” issue. First, he reminded Voll that the Yung sale was on September 15, 2000, and Jorgensen was involved with the discussions and approval of the ―business purpose.” He erroneously believes that this was before Voll joined Grant Thornton. Secondly, he stressed that the Yung fact patterns are typical for companies interested in using this product and to push ―business purpose” to an extreme would result in making the product non-saleable. (PX 1117).

191. Voll responded the same day. (PX 1178). After saying that they are not afraid to step real close to the legal line, he explains that court cases are not helping them as much on business purpose and expresses his concern with the step transactions doctrine. He stated that fact patterns were key and that it was not until he and Shin made further, rather lengthy, factual inquiries into other shareholder investments that he developed the business purpose argument for Yung that had not been presented to them. The court finds this confirms Voll's unstated opinion that it was well after December 31, 2000, that Grant Thornton had the necessary information to issue a ―more likely than not" opinion.

192. On May 15, 2001, J. Michel sent an e-mail to Keith and Hurley with a copy to Voll which inquired as to which two of the tests, the mechanical economic substance test or the tax structure test, did the Lev301 fail to meet which would require the product to be subject to ―list maintenance." (PX 454). Keith responded with a flow-chart to assess the IRC §6112 listing requirement. He noted that this chart did not assess the need for ―disclosure" under IRC §6011 or ―registration" under IRC §6111. (PX 455). Keith then notified Jorgensen of this communication. (PX 117). This discussion about disclosure and list maintenance was five months after the Yung transaction. Additionally, J. Michel had already concluded that two of these tests were met. (See §§VI(B)¶92, VI(C)¶110,supra). In an e-mail string on May 17th, Voll responds and agrees that the listing question had not been answered because Grant Thornton was going to list but that the client was being told that the Lev301 was not a ―list maintenance" transaction. J. Michel agreed that this issue needed to be cleared up. (PX119). Voll opined that the transaction need not be listed. Stutman opined that the listing may be required even if there is a ―more likely than not" opinion. (PX 120). Voll's follow-up e-mail to Stutman later that day outlines that his rationale is in the opinion letter and states his belief that the Opinion should be

relied upon. (PX 120). No written e-mail was presented as evidence to indicate that the listing issue was ever resolved. Jorgensen testified he couldn't remember if Grant Thornton concluded if it was required to maintain a list. (Jorgensen Test.). The court notes that more than five months after the transaction closed, Yung was still not informed that a ―list maintenance" requirement was a possibility/probability even though Grant Thornton's Client Matrix notified its field agents of the requirement to keep an internal list. The court makes this finding despite Grant Thornton's argument at trial that the Appendix of the final Opinion Letter, the first copy of which Yung received in February, notified Yung. This array of facts illustrates the confusion and lack of coordination Grant Thornton exercised in the preparation and sale of this product.

193. On May 21, 2001, William Yung signed a ―Representation Letter for the Opinion Letter of Grant Thornton LLP" for Wytec, (D 13), and on June 19, 2001, for Casuarina, (D 12, PX 1054). These representations did not include a representation that the note/loan/mortgage was ―nonrecourse" or the term ―bona fide business purpose" as was later required from product purchasers. (D13). The Wytec letter was e-mailed to T. Mitchel for print on May 17, 2001. (PX1053). These letters also appear in this litigation as PX 1048 and GT 204. Jorgensen testified that the language of these letters, specifically #7, 9, 10, and 11, were used to make the determination that the transaction was nonrecourse. The court notes that Jorgensen did not testify that he read the note, mortgage or lien documents, and that testimony and billing documents prove that Keith, Michael and Voll did read those documents. (PX 8). Thus, the court finds that Grant Thornton made its own determination as to the effect of the transaction documents and did not rely on Yung's representations; representations created by Grant Thornton to support its finding.

194. On May 24, 2001, the draft of the Client Matrix Lev301 Cheat Sheet was circulated to Michel for review. (GT 1559). It still contained the statement that the Lev301 analysis was supported by an accompanying opinion letter from a prestigious Washington D.C. law firm, which was untrue. It also did not stress that clients must have a ―bona fide business purpose" or that transaction financing must be ―nonrecourse" in nature. J. Michel‘s corrections included the removal of the prestigious Washington D.C. law firm opinion letter, IRS exposure as a risk, potential tax savings, and the ―more likely than not" confidence level from the notice. (GT 1397). The claim that Grant Thornton had successfully delivered this product to several clients appears on each draft with a reference to Columbia Sussex Corporation as a successfully delivered product. This was three months before the opinion letter was issued to Yung. The court finds Grant Thornton misrepresented to its field agents, and through them to its clients, that the product was viable.

195. On May 30, 2001, a presentation by Jorgensen and J. Michel called ―Getting It Done" was rolled out to the field agents. The presentation revisited Lev301 as a Level 1 product. This presentation did not stress ―bona fide business purpose" or ―nonrecourse" of the transaction financing. It concludes that a constructive dividend only exists if the shareholders were primary obligors. J. Michel, Hurley and Voll are named as the contact persons. (PX 110).

196. Following the decision to recommence sales of the Lev301, Bottiglieri (with J. Michel‘s assistance) approached the CFO of his client Thomas Publishing Company (―TPC") with the strategy as a way for TPC to transfer a portfolio of securities, called the ―Rainy Day Fund," to its shareholders. (Bottiglieri Dep. 54:3-55:9, March 29, 2012).

197. TPC sent Grant Thornton‘s Lev301 proposal to its outside counsel, The Don McNicol Firm, for review. Marc Cohen (―Cohen"), a tax lawyer with the McNicol firm, reviewed the

proposal and authored a one page memorandum dated May 29, 2001, that concluded that the Lev301 did not work under the January 4th Regulations because TPC would remain obligated to repay the bank, making the loan a ―recourse" loan for purposes of §357(d). (PX 122-R). And because the TPC shareholders would not be expected to repay the bank debt, they would not assume the liability, and therefore could not reduce the value of the Rainy Day Fund distribution by the amount of the bank debt under the January 4th Regulations. (PX 122-R).

198. On May 30th Bottiglieri wrote Jorgensen and informed him of Cohen's conclusion that Lev301 did not work. (PX 942). Voll was provided with a copy of Cohen's memo, and after reviewing it determined that Cohen's analysis was correct. (PX 944). J. Michel and Bottiglieri then returned to TPC with a new proposal in which the loan between TPC and the bank would be nonrecourse to TPC, limiting the bank's recourse in the event of a default to the Rainy Day Fund. The revised Lev301 proposal was documented in a follow-up memo by Cohen, dated June 27, 2001. (PX 943-R; Trial Tr. 4126:17-4128:20 (Yale Test.)). Voll, Jorgensen and Gould continued to e-mail Bottiglieri in an attempt to convince Cohen that he was incorrect. (PX945).

199. Going forward, Grant Thornton required that the loan between the bank and the distributing company be nonrecourse in Lev301 transactions to avoid application of the January 4th Regulations, and required a representation to that effect from the client. (PX 250; PX 330; PX 333; PX 952; PX 968; PX 969; PX 976; PX 980; PX 1043; PX 1046; PX 1208; PX 1461). The nonrecourse requirement proved to be problematic for Grant Thornton on several occasions, and was the subject of numerous internal e-mails. (PX 185; PX 478; PX 315-R; PX 578; PX 350; PX 358; PX 1023).

200. J. Michel had reviewed the loan documents between the Cayman Corporations and Firstar prior to their execution, and knew that the loans were recourse to the two corporations.

(Trial Tr. 3681:5-3682:21 (J. Michel Test.); (PX 794; PX 1157). Voll had also reviewed the Firstar loan documents (PX 8 (12/15/00); see section V(C)¶113, *supra*) and received copies of the final executed Firstar loan documents in March of 2001. (PX 104). Because both Voll and J. Michel had participated in the discussions with TPC, both knew that Grant Thornton was repudiating the version of the Lev301 it had advised Yung to execute in December 2000. The court finds Grant Thornton did not ask for or obtain a representation from Yung during the engagement, before the December 2000 distribution or the August 2001 opinion issued or the September 2001 loan repayment, which stated that the loan was nonrecourse under Ohio law. (PX 163; PX 164).

201. By June 5, 2001, just five days after the ―Getting It Done" Presentation, an e-mail to Jorgensen from Richard Bayer, a Grant Thornton tax field agent in the New York office, indicated embarrassment with the Lev301 product because ―more than one client‘s corporate counsel" had pointed out Grant Thornton‘s failure ―to fully describe and disclose key areas" which were subject to aggressive interpretation by Grant Thornton. (PX1343). Voll and Jorgensen agreed to express confidence in the product while in New York and acknowledged that people would have initial reservations just like they did. Voll admitted that if ―the local partner runs for cover when questions are asked" the situation would become a calamity. (PX 1343). This situation continued to concern Voll so he had a discussion with Bottiglieri who reinterpreted his conversation with Bayer thus calming Voll. However, Voll confessed that the corporate tax lawyer is ―smart, arrogant, strong willed and well respected **and has hit the Achilles tendon that I always knew was there**" (emphasis added). (PX 1322; *See also* §V(B) ¶87, *supra*). He indicated that this lawyer should be persuaded that Grant Thornton has a ―credible" position even while he may continue to think the risk is too high. (PX 1344). In other

words, to persuade this lawyer that the Grant Thornton position could possibly be ―more likely than not.” (See ¶198-199, in which the lawyer is unconvinced and the product is changed.)

202. In early June, Michael Gould joined Grant Thornton. Gould, a lawyer, was assigned to work on the Casuarina and Wytec opinions. He was assigned to revise the Lev301 opinion to account for the January 4th Regulations. (PX 124). On June 29, 2001, a Voll e-mail reflects he was still working on the Yung business purpose, despite his May indication that he had made the business purpose fit. (PX 1178). He complained the Yung investment list was received only two days ago to help with the business purpose argument because Yung had changed the investment sentence in the representation letter. This e-mail states that two major court decisions were issued that week which affected the Yung transaction and needed to be analyzed. (PX 137). Voll testified that this e-mail conveyed his opinion that if they didn‘t get the business purpose straightened the Yung opinion was ―going nowhere”. (Voll Test.).

203. On June 30, 2001, J. Michel issued a Memorandum which stated: ―(c) THE NOTION OF ‗BUSINESS PURPOSE‘ WAS INTRODUCED TO THE PRODUCT BY A NEW TECHICAL CHAMPION AND IN RESPONSE TO THE JAN 2001 TREASURY DEPT 301 REGUALTIONS.” (PX 1036). This statement contradicts testimony by Grant Thornton witnesses ―that business purpose” was important to this Level 1 product at its inception and that Jorgensen, as Product Champion, was required to present, discuss and approve the use of this product by a client because of its importance. It contradicts testimony that Jorgensen determined the product was appropriate for Yung‘s participation at its introduction in July of 2000, and confirms that a ―more likely than not opinion” standard did not exist at the time Grant Thornton issued the December 28, 2000, ―opinion letter”. (PX 1036).

204. On July 10th, the same day Voll was trying to bolster Bottiglieri‘s position with Cohen, he informed J. Michel that he is still working on the Yung opinions and was still concerned about business purpose. (PX 145). This e-mail is of significance because it directly contradicts Voll‘s prior positions that the statutory construction language is the primary basis for pushing the opinion over 50% to a ―more likely than not" level.

205. On July 11, 2001, Gould was working on the ―economic substance portion" of the Yung opinion. (PX 148). On July 18, 2001, the Wall Street Journal reported on a renewed assault on Corporate Tax Shelters through the Introduction of Abusive Tax Shelter Shutdown Action filed July 17, 2001, in the U.S. House of Representatives by Rep. Lloyd Doggett. (PX 906). On July 19, 2001, Voll and Bottiglleri were still trading e-mails about ―constructive dividend" and the intricacies of state law defining the nature of the loan transaction and its relationship to the shareholders. (PX 952).

206. On July 13, 2001, the William J. Yung Family Trust filed its 2000 U.S. Income Tax Return which was reviewed by Grant Thornton. (GT 1552).

VII. *THE FINAL OPINION LETTERS, AUGUST 2001*

207. On August 7, 2001, Voll e-mailed J. Michel, Bottiglieri, Hurley, Gould, Stutman, Jorgensen and Carlson that he had remodeled the engagement letter for Lev301, particularly noting he was trying to achieve confidentiality without explicitly stating the opinion was confidential. (PX 538). This emphasized the thin line everyone knew Grant Thornton walked with this product.

208. On August 8 and August 13, 2001, Grant Thornton delivered the final Wytec and Casuarina opinion letters (―August Opinion Letters") to Yung. (PX 158; PX 163; PX 164). Voll, as ―technical champion" for the Lev301, and J. Michel, as product champion, signed off on

their issuance. Both Voll and J. Michel knew they stood to receive a commission on the engagement fee once paid in full by Yung. (PX 472; PX 1296). Jorgensen testified that he served as the impartial second reviewer of these opinions, however there is no external evidence to support this statement and the court finds that it is not credible. The only document introduced into evidence on this issue shows that J. Michel served as second reviewer, thus there was no actual impartial second review of the Yung opinions. (PX 167).

209. Early August e-mails discuss the time it took to produce the Yung Opinion Letter, and Horak asks to be provided with the “details on this mess” so he can determine allocation for billing responsibilities. (PX 158, PX 1186).

210. The August Opinion Letters, like the Draft Wytec Opinion Letter, contain an introductory paragraph and are divided into five parts labeled: “OPINION”; “FACTS”; “REPRESENTATIONS”; “ANALYSIS”; and “CONCLUSION.” (PX 163; PX 164). The August Opinion Letters also contain two appendices identical to the ones contained in the Draft Wytec Opinion Letter. (PX 163 at CS000646-CS000647; PX 164 at CS000523-CS000524). Unlike the Draft Wytec Opinion Letter, the August Opinion Letters contain several attachments, including the Firstar loan documents. (PX 163 at CS000648-CS000699; PX 164 at CS000525-CS000569). Section 6.2 of both pledge agreements, and the accompanying bank notes, confirm the recourse nature of the loans. (PX 163 at CS000664; PX 164 at CS000543; Krug Dep., Vol. 2, 26:1-28:6; 29:1-30:21; 31:25-32:12).

211. The six opinions contained in the August Opinion Letters are substantively identical to those found in the 2001 Draft Wytec Opinion Letter reviewed by T. Mitchel. T. Mitchel only reviewed the “OPINION” and “FACTS” sections of the Wytec letter to ensure that the opinions were consistent with the December 28th Letter and the Draft Wytec Opinion Letter, and that the

facts were accurate. (Trial Tr. 707:6-707:25 (T. Mitchel Test.)). T. Mitchel relied on Grant Thornton as the tax expert and so did not review the ―ANAYLSIS" sections, or appendices I or II, of either opinion, nor was he directed to do so by anyone at Grant Thornton. (Trial Tr. 707:18-710:25 (T. Mitchel Test.)).

212. To account for the January 4th Regulations, Voll intentionally characterized the loan obligation as ―nonrecourse" in both opinion letters. (PX 163 at page 20, ¶5, line 2 – CS000591; PX 164 at page 21, ¶2, line2 – CS000469). The nonrecourse nature of loan was a determination of Ohio law that Grant Thornton as a public accounting firm was not qualified to make. (PX 104; PX 1031; Trial Tr. 1447:24-1449:16 (Hamersley Test.)).

213. Grant Thornton‘s opinions were also based on the existence of a motivating non-tax corporate (as opposed to shareholder) ―business purpose." (PX 163; PX 164; PX 1205; Trial Tr. 1484:10-1486:16 (Hamersley Test.)). No representation was made by Yung to Grant Thornton that the Wytec and Casuarina distributions were primarily motivated by a non-tax business purpose. (PX 163; PX 164). Furthermore, Jorgensen, J. Michel and Voll were all aware that Yung‘s primary motivation for making the Lev301 distributions was the elimination of U.S. federal income taxes on the transfer of the Cayman cash, and that the primary motivation of taxpayers utilizing the strategy would always be tax savings. (PX 120; PX 291; PX 1036; PX 1164; PX 1177; PX 1178; PX 1188; PX 1254).

214. Finally, Grant Thornton‘s August Opinion Letters were based on its conclusion that the Lev301 would survive application of the step transaction judicial doctrine. The foundation for this conclusion was Grant Thornton‘s factual determination that the Lev301 was ―nothing more than one would expect where a company decides to finance a distribution of an asset." (PX 163; PX 164). Grant Thornton could not have reasonably believed this statement. (Trial Tr. 1476:2-

1483:24 (Hamersley Test.)). The evidence shows that Grant Thornton marketed the Lev301 as a mechanism by which to avoid federal income taxes on shareholder distributions, not as a mechanism by which to finance a distribution of assets. (PX 6; PX 9; PX 11A; PX 42; PX 474; PX 626; PX 1254).

215. Grant Thornton issued the Wytec and Casuarina Opinion Letters to induce Yung into paying the balance of the $900,000 engagement fee. (PX 928). Grant Thornton also wished to avoid liability for the interest charge on the $30,000,000 Firstar bank loans it had induced Wytec and Casuarina to enter. (PX 1056).

216. On August 21, 2001, a Wall Street Journal article was published which again calls into question BOSS strategies; this caused Jorgensen to pause the Lev301 sales pending a full read. (PX 836).

217. On September 13, 2001, Stutman e-mailed an article from the Journal of Taxation regarding attempts to unwind dividends, and indicated it was worthwhile regarding an ―out strategy" on leveraged distributions (PX 176).

218. On September 26, 2001, additional regulations were issued that caused another review of the Lev301. The initial reaction from Voll was that it didn't create a concern. (PX 910). The e-mails communicated that the necessity of a nonrecourse nature of the liability for Lev301 is now very clear. (PX 181). On September 28, 2001, Yung paid off the loan which was the basis of this transaction and the shares then had full value to the shareholders. On October 7, 2001, the form 1040 for the Yungs was filed after review by Grant Thornton. (PX 690).

219. In November of 2001, while dealing with a different client's transaction which converted a nonrecourse loan into a recourse note, Gould e-mailed Voll an analysis of the definition of nonrecourse. (PX 547). In December of 2001, inquiry about the tax accounting for the

―leveraged distribution” product was raised by a Tom Walters to a Mark Scoles. In this string of e-mails, Walters indicated some of the tax partners were a little leery that a tax was not created. Scoles responded that he was not sure if the accounting treatment had been reviewed and attached a memorandum that was prepared for and shared by J. Michel. Scoles characterized the leveraged distribution as two transactions, a borrowing and a distribution. Walters is trying to run down the ―GAAP.” Horak asked if they talked to J. Michel and Walters advised he had started his inquiry with Michel and he did not have anything available but a ―superficial” memo. (PX 1297).

220. On December 27, 2001, J. Michel e-mailed regarding the Benefical ReUse transaction. He stated that he had read the documents and was aware of the recourse vs. nonrecourse concern in the promissory note. He stated,

> I view the documents as being effectively nonrecourse with a limited carve-out for potential liabilities arising from default. Those liabilities being limited to collection and collateral conversions costs. **In no event would insufficiency of collateral value obligate the borrower to contribute or be liable for the deficiency**. This is the language that we do not yet see in the Pledge Agreement. The technical issue from my side is IRC SEC 357(d)(2) which does not define the term _nonrecourse liability.‘ I am comfortable that we will be able to render our tax opinion that this instrument will not impair the application of IRC SEC 301(b)(2)(B) (even as interpreted by the Temp Treas Regs issued under Sec1.301-1 in January 2001).

(emphasis added; PX 1046). It is clear from this e-mail that J. Michel was aware of the necessary language for nonrecourse loan documents and yet he did not identify this flaw in the Yung documents to the Yungs nor discuss it with Voll.

221. Grant Thornton‘s opinions for U.S. Bancorp (―USB”) and Baker, the other two Lev301 transactions that occurred prior to the issuance of the January 4th Regulations, were not issued until March of 2003. (PX 856; PX 1462). For those opinions, Grant Thornton simply concluded that the January 4th Regulations did not apply because the transactions occurred prior to the

effective date of the distributions. (PX 856; PX 1462). Grant Thornton's USB and Baker opinions illustrate its failure to address and reconcile the January 4th Regulations with the recourse nature of the bank loans involved in those transactions.

222. Pre-load Concrete Structures, Inc.'s draft of its Lev301 resolution titled ―Consent to Action in Lieu of Meeting of Directors" in January of 2002 clearly indicates that Voll and Grant Thornton were aware of the prior failure to assure the clients' transactions were nonrecourse and the necessity that the clients' representations reflect this knowledge. (PX 848, 845).

223. In February of 2002 the IRS requested Grant Thornton disclose all of its potentially abusive tax shelters under IRC §6111 and Treas. Reg §301.6112.1T. In a Memorandum of February 7, 2002, Voll and Gould outlined the reasons that Lev301 was not such a transaction. This is the first internal written statement to file by the firm concerning all of these Lev301 issues. (PX 1191).

224. On February 8, 2002, Stutman opined that the Lev301 is not a potentially abusive tax shelter. (PX 209).

225. On February 14, 2002, J. Michel e-mailed Gould a portion of the opinion letter which indicated that the Firm ―may have" to maintain certain information (―list"). (PX 466). This harkens back to Voll's concern on May 15, 2001. Gould's somewhat sarcastic response (PX 192) sums up the failures of Grant Thornton to be direct about list maintenance and the way it was included in the appendix. He stated:

> I do not like. (1) We are maintaining a ―list." (2) Just because we are creating and maintaining the list does not mean anything. (3) BUT, sometimes the IRS requests a list EXACTLY LIKE the one we are maintaining. (4) If the IRS asks for this list, we will fight, but if we lose we will have it ready for them. Here is the possible dialogue: IRS: Do you have any listable transactions? GT: No. IRS: What about the engagement letter we got a hold of, you are maintaining a list, right? GT: Right. IRS: Why? Guilty conscience? GT: Well, we have something that could be considered a listable transaction, we'd fight you on it, but if we lose, we have

> something to give you immediately. IRS: So, you are talking you ―might" have a listable transaction. GT: Right. IRS So even YOU thing [sic] you MIGHT have a listable transaction"? GT: Yes. IRS: Well, thanks for highlighting for us where to fight you. Now how about that one-stop-shopping list that will give us ammunition to audit your clients.

(PX 466). This dialogue clearly recognized that Grant Thornton knew this was a listed transaction and failed to adequately notify Yung, either intentionally or through the use of a confused and diffused communication and research structure, acts of gross negligence.

226. In May of 2002 J. Michel responded to a question from Voll and pointed out the language in the loan documents that detailed the lender‘s sole recourse is in §6.2 of the pledge agreement. Voll responded to J. Michel that this language was identified, and the concern was the ability of the lender to collect against the general assets of the debtor in the event of default and if a lawyer would interpret it as a full-fledged nonrecourse loan. (PX 477).

227. Agahi completed a memorandum for Voll around May 23, 2002, on the subject of nonrecourse loan/liability. He concluded that the U.S. transaction could not be conclusively characterized as nonrecourse. (PX 1143). Throughout May and June of 2002, Agahi works with Voll and Gould on several Lev301 transactions and expresses ongoing concerns about the nonrecourse definition and the language of the Pledge Agreement at 6.2. (PX 969, PX 968, PX 246, PX 248).

228. On June 18, 2002, the Think Tank met: Stutman, Jorgensen, Gould, Shin, Agahi, Auclair, and Voll were present and J. Michel was absent. There was a discussion about the disclosure (Treas. Reg. Sec. 1.6011-4T) and registration (Treas. Reg. Sec. 301.6111) amendments to the Tax Shelter Regs. E-mails in June continue to express concern about list maintenance and BOSS similarities. (PX 250, PX 476, PX 251, PX 567).

229. On June 21, 2002, Stutman requested copies of the Lev301 opinions for outside counsel to review in connection with the IRS tax shelter exam. Gould sent him the Wytec 8-7-01 and the Casuarina 8-13-01 documents, as well as others. (PX 253, PX 970).

230. On June 25, 2002, the IRS summons was served requesting information from Grant Thornton regarding list maintenance transactions. (PX 344). On June 28th, Stutman began the process of removing Lev301 from the Client Matrix again, indicating in the memorandum that it was because of the disclosure and reporting requirements of the new regulations. (PX 568).

231. It was in this time frame that Gould prepared an Outline of the Wytec Opinion. (PX 480). He testified that while he authored this document he didn't know why. In this document Gould documented that the Treasury Notes were the only assets subject to the nonrecourse bank lien. He remembered that at some point he was told that nonrecourse was important. (Gould Test.). The court finds this testimony concerning lack of memory to be disingenuous and thus not credible.

232. On July 1, 2002, the Lev301 was removed from the Client Matrix. (PX 916). It is clear from the e-mail of Grossman on July 2, 2002, kidding Agahi about the potential for incarceration, that the notice of removing the Lev301 was taken very seriously by the field agents. (PX 917).

233. Between July 5th and July 11th, Voll and Gould worked on a Tax Shelter Memorandum for Horak. The purpose of the memorandum was to once again advise if Grant Thornton was required to maintain a list of the Lev301 product transactions. The testimony, e-mails and trial arguments show that this decision had already been made by Grant Thornton. Grant Thornton maintained a list and testified at trial that they fully informed their clients, specifically the Yungs, of this requirement orally at the first product meeting in July of 2000: which testimony

the court finds lacks credibility. This memorandum was also to address the regulations‘ effect of making it more difficult to distinguish the Lev301 transaction from those identified as –substantially similar” to *per se* reportable transactions. (PX 438, 484, 934, 486, 1301, 1196, 1302, 935, 1197). In a July 11th memorandum to Voll, Gould indicated his understanding that the Lev301 strategy was not organized or sold to Wytec or Casuarina after February 28, 2000, therefore it would not have to be listed. (PX 482). This e-mail confirms the continued confusion at Grant Thornton about this product and these clients, the Yungs. It is contrary to Grant Thornton‘s testimony at trial that their opinion was not to be relied upon by the Yungs until issued in August of 2001. As an aside, any tax return filed before February 28, 2000, would have been for events prior to the creation of the Lev301 or any of the transactions. (PX 482).

234. A July 12, 2002, e-mail from Voll to J. Michel and Stutman is remarkable because it uses the phrase –audit lottery” which is a phrase that Grant Thornton attributes to T. Mitchel. (PX 1199; *See also* §IV(A) ¶51, *supra*). A July 23rd, 2002, e-mail from Voll is remarkable because he states, –we would want a business purpose, economic substance, non-step transaction factual background‘‘ when discussing the Lev301 with a new client. (PX 1200). The court finds this amounts to an admission that these attributes are not in the prior transaction.

235. On September 5, 2002, Stutman was considering restoring Lev301 to the Client Matrix. (PX 273). He reinstated it on September 30, 2002. (PX 1016).

236. In October of 2002, the issue of nonrecourse surfaced again. Voll was searching for attorney affidavits to confirm that a loan was nonrecourse. He expresses concern that Grant Thornton not be viewed as providing an opinion on this issue. J. Michel hoped that an e-mail from the Vice-President of Provident bank would be sufficient on this issue and would put it to rest. Voll continued to say that, while the V.P. said the notes were nonrecourse, it was critical

that the opinion indicate that the loan was nonrecourse. (PX 1031). Voll suggested an opinion based on a client's representation that the note was nonrecourse could suffice if they couldn't get an attorney opinion on the issue. (PX 578). At trial Grant Thornton testified that it was the Yungs who represented that the loan/note transaction was nonrecourse. They referenced the body of the letter, not the specific representations from Yung, to prove this point. Additionally, Grant Thornton argues that, despite J. Michel's testimony that he knew the loan documents were recourse, this one line in the opinion was sufficient to notify Yung that he was representing the loan as nonrecourse. Grant Thornton argues this even though the volume of e-mails in this case clearly indicate they were confused about this concept. An October 7, 2002, e-mail from Voll to Stutman makes it clear that Voll had been worried about recourse and nonrecourse notes. (PX 1203). This concern is supported by the October e-mails exchanges regarding the nature of notes and loan documents. (PX 975, 976, 1031). On November 4th, J. Michel wrote a full memorandum on the issue of nonrecourse. In essence he disagreed with the conclusion being championed by Voll and said that ―they can reach a conclusion as to whether the loan documents" are nonrecourse. Again he proposed that the client make the representation and argued that there was no magical language that was dispositive of the issue. (PX 1484). This approach is the same that was argued by Grant Thornton at trial, that the representations of the client can be relied upon to assume that the transaction was nonrecourse.

237. Even if Grant Thornton had relied on false facts that the loan was nonrecourse when rendering its ―more likely than not" opinion, no reasonably competent federal tax practitioner would have issued a more likely than not opinion in support of the Lev301, even prior to the issuance of the January 4th Regulations. (Trial Tr. 1510:2-1510:13 (Hamersley Test.)).

238. The court finds the testimony of Plaintiffs' expert Michael Hamersley to be most persuasive on the issue of whether Grant Thornton's issuance of the ―more likely than not" opinions fell below the standard of care applicable to federal tax practitioners.

239. The court further finds that the factual question of whether the Firstar bank loans were recourse or nonrecourse under Ohio law was dispositive of Grant Thornton's opinions (R. Voll Dep. 655:17-656:10, Mar. 15, 2012 (Vol. 3)), and that Grant Thornton was not qualified to determine whether the Firstar loans were recourse or nonrecourse under Ohio law. (R. Voll Dep. 367:1-14, 392:5-10, Feb. 9, 2012 (Vol. 2), 657:6-17, Mar. 15, 2012 (Vol. 3); (PX 1037). In light of Mr. Hamersley's expert testimony, and Grant Thornton's unauthorized practice of law in connection with the Lev301 opinions, the court concludes that Grant Thornton failed to exercise even slight care in issuing its opinions to the Yungs and the '94 Trust, and that its conduct constituted gross professional negligence.

240. Yung and the '94 Trust relied on Grant Thornton's August Opinion Letters in deciding to not report the $30,000,000 in distributions on their 2000 federal income tax returns (―2000 Returns") (PX 690; PX 1444) and in deciding to not report the repayment of the $30,000,000 on their 2001 federal income tax returns (―2001 Returns"). (Trial Tr. 710:19-711:17 (T. Mitchel Test.)); (PX 689; PX 1420).

VIII. *YUNGS' 2000 TAX RETURN; REVIEW '94 TRUST 2000 TAX RETURN*

241. Williams, while a Grant Thornton employee, prepared and reviewed the Yungs' 2000 return, and reviewed the '94 Trust's 2000 return. (S. Williams Dep., Vol. 1, 85:1-86:21). Williams was aware that the Lev301's had occurred, but did not advise the Yungs or the '94 Trust that it would be in their best interests to report the transactions to the IRS to minimize or

eliminate the risk of penalties. She also did not conduct an independent investigation as to the tax consequences of the Lev301, but instead relied on J. Michel. (*Id.* at 88:22-87:2 & 88:7-98:17).

242. The unrebutted testimony of Yung's expert Donald Fritz established that a reasonably competent tax preparer in the greater Cincinnati area would have conducted an independent investigation of the penalty risks associated with the Lev301 and would have advised the Yungs and the '94 Trust that failing to report the $30,000,000 in income created a substantial risk of being penalized by the IRS on audit, even with Grant Thornton's opinion. (Trial Tr. 2290:24-2278:14 (Fritz Test.)).

243. The Firstar bank loans taken out for the Lev301 transactions were paid off at the end of September 2001. (PX 1056; PX 1057; Trial Tr. 711:18-712:15 (T. Mitchel Test.)).

IX. *2002 IRS EXAMINATION OF GRANT THORNTON REGARDING ITS COMPLIANCE WITH THE REGISTRATION AND LIST MAINTENANCE TAX SHELTER REGULATIONS*

244. In early 2002 the IRS initiated an examination of Grant Thornton (―IRS Examination") to determine whether it was complying with its list maintenance and registration obligations under the February 28th Tax Shelter Regulations and subsequent changes thereto. The examination expressly targeted Grant Thornton's promotion of potentially abusive tax shelters. (PX 475). Because of the purpose of the examination, partners associated with the Lev301 were aware that the examination substantially increased the risk that the IRS would obtain the names of its Lev301 clients, increasing those clients' audit risk. (PX 475). Grant Thornton concealed the examination from the Yungs and the '94 Trust until it became public in September of 2003. (Trial Tr. 2405:16-2406:12 (T. Drake Test.); Trial Tr. 725:12-727:7 (T. Mitchel Test.); see ¶¶223 & 230, *supra*).

X. *JUNE 2002: IRS TAX SHELTER REGULATIONS*

245. In June of 2002 the IRS issued additional regulations targeting abusive tax shelters (―June 2002 Regulations"). The regulations provided a definition of the term ―substantially similar" as that term appeared in the February 28th Tax Shelter Regulations. The IRS cited promoters‘ narrow interpretations of that term as the impetus behind the regulations. (PX 250).

246. The June 2002 Regulations once again prompted Grant Thornton to cease marketing the product to clients. (PX 568; PX 916; see ¶230, *supra*). The removal was not conveyed to Yung or the '94 Trust, despite internal discussions about the application of the new regulations to the Wytec and Casuarina transactions. (PX 482). In the face of this IRS investigation, in September of 2002 the Lev301 was again approved for sale and posted to the Client Matrix. (PX 277; PX 1016).

XI. *YUNGS' 2001 TAX RETURN; REVIEW '94 TRUST'S 2001 TAX RETURN*

247. In September of 2002 Grant Thornton prepared the Yungs‘ and the '94 Trust‘s 2001 tax returns. (PX 1420). Grant Thornton did not notify the IRS of the repayment of the Firstar bank loans in September of 2001 on those returns. (Trial Tr. 717:18-718:9 (T. Mitchel Test.)). Grant Thornton‘s intentional failure to advise the Yungs and the '94 Trust to report or disclose the Lev301, in light of the IRS examination and the June 2002 Regulations, was in furtherance of its efforts to conceal its prior negligent and fraudulent behavior towards the Yungs.

248. At some point in 2002, the IRS learned of the Lev301 product through documents produced by Grant Thornton during the examination. (PX 1306). Throughout September, October, and November, Stutman was requesting documents from the NTO and Grant Thornton field agents. (PX 279, PX 936, PX 1306). In December of that year, the IRS issued a summons to Grant Thornton asking for documents relating to its promotion of the Lev301 and the names of

its clients who participated in the product. Grant Thornton did not notify the Yungs or the '94 Trust about the summons, which further increased the likelihood that the Yungs and the '94 Trust would be audited by the IRS on account of their participation in the Lev301. (Trial Tr. 725:12-727:7 (T. Mitchel Test.)).

XII. *NOVEMBER 2002: IRS AUDIT OF COLUMBIA SUSSEX CORPORATION UNRELATED TO LEV301*

249. In November of 2002 the IRS initiated an audit of CSC for reasons unrelated to the Lev301. Grant Thornton was hired by CSC to manage the audit, which covered the 2000 tax year. (Trial Tr. 719:2-720:3, 723:16-19 (T. Mitchel Test.)).

250. In February of 2003 CSC received a standard Information Document Request (―IDR") from the IRS asking whether CSC had ―directly or indirectly" participated in any transactions that were the same as or substantially similar to a listed transaction (―IDR No. 6"). (PX 627). Because CSC was an S-Corporation, IDR No. 6 effectively asked whether Yung had individually participated in any listed transactions, including Notice 99-59 transactions. (PX 627).

251. T. Mitchel reviewed the IDR in full, and became concerned that Yung should disclose Lev301 to the IRS as a transaction ―substantially similar" to Notice 99-59. (Trial Tr. 722:20-723:19 (T. Mitchel Test.)). He consulted J. Michel who told him that the Lev301 was not substantially similar to Notice 99-59, despite Voll's conclusion in January of 2001 that Lev301 was substantially similar. *(Id.* at 723:16-725:1). J. Michel was then charged with responding to the IDR, which he answered in the negative on behalf of CSC. *(Id.*; PX 1368). J. Michel responded on March 5, 2002, that it is ―our belief that no such transactions (or substantially similar transactions) were entered into directly or <u>indirectly</u> by the taxpayer." J. Michel's response was calculated to conceal Yung's involvement in the Lev301 from the IRS, and to conceal Grant Thornton's prior fraud in connection with the Lev301 engagement (PX 1350), of which J. Michel was well aware because of his audit, tax review and Lev301 relationship with the inter-related Yung corporate structure. In February 2003 Yung applied for a gaming license in Nevada and was undergoing a routine audit in connection with this request. J. Michel was concerned with Nevada's questions about the decrease in dividends on the Yungs' tax returns. J. Michel stressed that Yung would not disclose anything more than advised by Grant Thornton. Stutman shared this concern and was sensitive to the fact that the state Gaming Commission might be entitled to be informed of the dividend distribution. (PX 304).

XIII. *SEPTEMBER 2003: DEPARTMENT OF JUSTICE ENFORCEMENT ACTION ON LEV301 SUMMONS*

252. On September 12, 2003, the U.S. Department of Justice, on behalf of the IRS, brought an action in the United States District Court for the District of Columbia to enforce various summons issued in connection with the IRS Examination. (PX 344; PX 345; PX 346; PX 347; PX 349; PX 352). Included among those summons sought to be enforced was the Lev301 summons issued in December of 2002. (PX 349). Similar actions initiated around that time by the IRS and Department of Justice aimed at tax shelters resulted in severe consequences, nearly destroying the accounting firm KPMG and causing several law firms to implode. (*See* M. Stutman Dep. 205:5 – 23, Nov. 10, 2011).

253. On September 17, 2003, along with the CEO Edward Nusbaum's notice to all of Grant Thornton that the ―summons enforcement" reported in the financial press ―comes as a total surprise to us" (PX 352), Voll sent a memo to Jorgensen in which he stated that he had not seen the loan documents until after they were executed and the distribution had been completed, and the language of this document raised issues about the nonrecourse nature of the obligation. He then described how they tried to remedy the problem. (PX 350). This memo once again

emphasizes that Grant Thornton was aware of difficulties that they did not share with Yung even at a time when IRS audits and gaming audits were being conducted.

254. Tom Drake, who had recently joined CSC as its new tax director, read an article in a trade journal that mentioned the summons enforcement action. (Trial Tr. 2405:16-25; 2419:20-2420:2 (T. Drake Test.)). Concerned that CSC's accounting firm was being sued by the government, he sent the article to T. Mitchel, who learned of the examination for the first time. (PX 630). To that point, T. Mitchel had been unaware that Grant Thornton was under examination by the IRS for its sale of the Lev301 product. (Trial Tr. 2405:16-2406:12 (T. Drake Test.); Trial Tr. 725:12-727:7 (T. Mitchel Test.)).

255. After receiving the article from Drake, T. Mitchel met with J. Michel and was told that Grant Thornton was likely to comply with the Lev301 summons, and that the names of the participants in the Wytec and Casuarina Lev301 transactions would be disclosed. (Trial Tr. 729:3-732:17, 738:21-740:8 (T. Mitchel Test.); PX 631).

256. In October J. Michel met with T. Mitchel and informed him that Grant Thornton was going to comply with the Lev301 summons, and that the names of Wytec, Casuarina, the Yungs, the GRATs and the '94 Trust would be turned over to the IRS. (Trial Tr. 729:3-732:17, 738:21-740:8 (T. Mitchel Test.)).

257. Shortly after that meeting, J. Michel wrote Yung a formal letter advising him of Grant Thornton's intent to comply with the Lev301 summons, and that the names of the participants in the Wytec and Casuarina Lev301 transactions would be disclosed to the IRS. (Trial Tr. 738:21-740:8 (T. Mitchel Test.); PX 634). Around this time, J. Michel recommended Dan Dumezich (―Dumezich") of the law firm Mayer Brown Rowe & Maw (―Mayer Brown"). (Trial Tr. 738:21-740:8 (T. Mitchel Test.); PX 635).

258. On January 5, 2004, J. Michel wrote to T. Mitchel offering Yung and the '94 Trust limited representation before the IRS in the event of an IRS audit. (PX 366).

XIV. *MAY 2004: IRS AUDIT OF THE YUNGS AND THE '94 TRUST CONCERNING THE LEV301 TRANSACTION*

259. The following month Grant Thornton turned over various documents containing the identities of Yung and the other Lev301 participants to the IRS. (PX 637). Drake, who was attempting to wrap-up the CSC audit that had begun in 2002, was contacted by the IRS agent responsible for that exam, and informed that the CSC audit would be expanded to include Yung's individual tax returns for the years 2000 and 2001. The examination agent also expressed concern that the Lev301 had not been disclosed to the IRS by Yung in response to IDR No. 6. (Trial Tr. 2431:13-2434:2 (T. Drake Test.)).

260. On March 31, 2004, J. Michel e-mailed Gould that they were holding off a Lev301 transaction because of the IRS examination of Wytec and Casuarina. (PX 1220).

261. The '94 Trust received its notice of audit in May of 2004. (PX 1419).

262. After receiving notice of the audit, the Yungs and the '94 Trust retained Dumezich to represent them, in consultation with J. Michel. (PX 1058). Dumezich was a former employee of Grant Thornton, and his firm represented Grant Thornton in other matters. (PX 997). J. Michel encouraged the use of Mayer Brown to ensure that the firm's advice to the Yungs and the '94 Trust would be tempered by its friendly relationship with Grant Thornton.

263. In May 2004, the Yungs and the '94 Trust received the first round of Lev301 IDR's from the IRS. Drake requested that J. Michel respond to IDR number 26, question 23 (―IDR No. 26"), which inquired about J. Michel's response to IDR No. 6:

> Please explain your position regarding the similarities of this transaction and the transaction described in Notice 99-59 … Please note that the notice 99-59 was identified on IDR # 6 … as one of the listed transactions that we requested disclosure. The response received stated that the taxpayer, Columbia Sussex

> Corporation and its shareholders, did not directly or indirectly enter into a transaction similar to Notice 99-59. The response we received was from the representative, John Michel of Grant Thornton.

(PX 639; GT 1445).

264. J. Michel provided a seven page response to IDR No. 26 in June of 2004, taking the position that the Lev301 was not substantially similar to BOSS. J. Michel provided his position statement directly to Mayer Brown, which adopted the same position vis-à-vis the IRS. (PX 374; PX 375; PX 1059).

265. Frishman, the partner in charge of tax practice policy and quality, made it his practice to involve himself in the audits of the Grant Thornton clients who purchased the Lev301 product. (*See, e.g.,* J. New Dep. 91:9-92:1, Mar. 21, 2012). Frishman became involved in Yung's audit in August of 2004. (PX 378; PX 379). Frishman was a personal friend of Dumezich's, and corresponded with members of the Mayer Brown firm directly about the Yung audit. (Frishman Dep. 138:1-139:1, Nov. 11, 2004 (Vol. 1); PX 379).

266. The finalized response to the portion of IDR No. 26 referencing Yung's failure to disclose the Lev301 in response to IDR No. 6 was e-mailed on November 29, 2004, with advice from Frishman, who also directed Dumezich not to contact J. Michel. The response became only five lines long. (GT 1567; PX 396; PX 641; PX 676). On the same day, Grant Thornton permanently removed the Lev301 from the Client Matrix in response to pressure from the IRS. (PX 393; PX 397). In addition to permanently removing the product from the Client Matrix, Grant Thornton ceased issuing opinions to clients for transactions that had occurred prior to the removal. (Wood Dep. 17:14-19, 24:23-25:2, Apr. 18, 2012; PX 683; PX 684). Neither Yung nor the '94 Trust were informed that Grant Thornton had ceased selling or defending the transaction. (*See, e.g.*, Trial Tr. 717:18-22 (T. Mitchel Test.)).

XV. *JUNE 2005: IRS ASSESSES BACK TAXES AND PENALTIES FOR PARTICIPATION IN THE LEV301 TRANSACTIONS*

267. On June 6, 2005, the IRS issued its Notice of Proposed Adjustment to the Yungs and the '94 Trust. (PX 410). The Notice of Proposed Adjustment concluded that the Lev301 transactions were fully taxable, and assessed a 20% penalty under §6662 of the I.R.C. against both the Yungs and the '94 Trust. (PX 410). The final examination reports were issued on May 8, 2006. (PX 1430; PX 1431; PX 1437). Yung appealed from examination report shortly thereafter. (Trial Tr. 2481:21-2481:24 (T. Drake. Test.)).

268. During the examination period, J. Michel continued to maintain the position with T. Mitchel and Drake that the Lev301 was a defensible tax position, and that the Yungs and the Trust should challenge any attempt by the IRS to assess penalties. (Trial Tr. 730:9-730:15, 733:15-734:9 (T. Mitchel Test.); PX 416; PX 429; PX 1432; PX 1433; *see also* J. New Dep. 91:12-92:1, Mar. 21, 2012). Ultimately, Grant Thornton conceded in a ―Closing Agreement on Final Determination" with the IRS intended to close-out the IRS examination that Wytec and Casuarina Lev301 transactions were substantially similar to BOSS. (PX 798).

XVI. *IRS SETTLEMENT*

269. On January 26, 2007, T. Mitchel, Drake, Rich Fitzpatrick (CSC's CFO at the time), Dumezich and J. Michel met at CSC's offices to discuss settlement with the IRS. (PX 428; PX 1435; Trial Tr. 2482:10-2485:7 (T. Drake Test.)). J. Michel was invited to the meeting because of a provision in the Engagement Letter that allowed Grant Thornton to have input on that issue. (Trial Tr. 752:17-753:18 (T. Mitchel Test.)). At the meeting, Dumezich presented various strategies in pursuing the appeal of the IRS assessment. When J. Michel was asked for his input, he agreed that settlement was the best option. (Trial Tr. 752:17-753:18 (T. Mitchel Test.); Trial Tr. 2482:10-2485:7 (T. Drake Test.); *see also* Trial Tr. 3741:22-3742:22 (J. Michel Test.)).

270. A month later, the Yungs and the '94 Trust reached a settlement with the IRS, which was ultimately approved on June 11, 2007. (PX 491; PX 492; PX 1438). The IRS settled with the Yungs and the '94 Trust due to the ―hazards of litigation" relating to the 20% penalty assessment. The ―hazards of litigation" assessment made by the IRS was not based upon the merits of Grant Thornton's arguments in support of the Lev301 strategy. (PX 28; PX 163; PX 164; Trial Tr. 2499:16-2500:13 (T. Drake Test.)). The Yung settlement included the CSC audit. (*Id.* at 2506:12-2509:16). In the settlement, the IRS agreed to reduce the §6662 penalty to 13% of the tax due. (*Id.* at 2405:4-2505:13). No concession was made on the taxes due or the interest owed. (*Id.* at 2505:23-2506:11; PX 492).

<u>EXPERT TESTIMONY: TAX AND PROFESSIONAL RESPONSIBILITY</u>

I. *FOR THE PLAINTIFFS: MICHAEL HAMERSLEY, ESQ.*

1. The Plaintiff called Michael Hamersley, Esq., MBA, (―Hamersley") to offer his opinions on tax matters and tax professional responsibility. His opinions are:

> 1) That the Grant Thornton Opinion Letter falls below the standard of a ―more likely than not" chance that it would be upheld in a tax court because the conclusions in this opinion were not accurate;
> 2) That Grant Thornton knew or should have known that Yung's business purpose for the transaction was not sufficient to sustain or avoid the application of a judicial doctrine and thus would not have supported the opinion;
> 3) That Grant Thornton breached the standard of care as regulated by Circular 230 in its preparation of the opinion letter;
> 4) That Grant Thornton knew or should have known that their actions and opinions violated the professional standard of care.

(VCR 4/27/12 9:00).

2. Hamersley testified to his qualifications and his Curriculum Vitae was entered as PX 1367. (Trial T. p. 36). The plaintiff moved to qualify Hamersley as an Expert in the area of Subchapter C transactions, Internal Revenue Code provisions relating to Subchapter C including IRC §§301

and 357, tax shelters, and the standards of care relevant to tax practitioners including Circular 230. Grant Thornton objected to Hamersley testifying as an expert and the court conducted a Daubert hearing to determine Hamersley's areas of expertise.

3. Hamersley's prior employment included a position as advisor at Ernst & Young and later in the National Tax Office for KPMG. He acted as lead corporate tax advisor on hundreds of domestic and cross-border corporate transactions. He taught internal and external training courses at KPMG on subchapter C. In 2000 he headed the Mergers and Acquisitions Tax group at KPMG. He was nominated and approved for partner of KPMG just prior to his whistleblower act regarding an audit he believed was unlawful behavior and promotion of tax shelters. He was placed on administrative leave from KPMG until the matter was resolved. He assisted with the investigation which resulted in Indictments and a deferred prosecution agreement between KPMG and the Department of Justice. This incident received nationwide attention including a PBS Frontline program called ―Tax Me If You Can." He assisted the Department of Homeland Security in its investigation of tax shelters, which included testimony about KPMG tax shelters. He testified about abusive tax shelters before the U.S. Senate Government Affairs Committee's permanent sub-committee on investigations to help them understand tax shelter promotions in the industry which included certain listed transactions such as Notice 2000-44, Son of BOSS, and Notice 2001-45 the §302 ―leaping basis" tax shelter. He also educated the Senate committee about listed transactions to assist them with their oversight duties. He helped develop and was a member of the California Franchise Tax Board, and the Abusive Tax Shelter Tax Force. In this role he taught internal training courses to auditors and legal staff in the area of abusive tax shelters.

4. In 2009 he established Hamersley Partners, a business and tax advisory firm which provides tax-related services in tax planning and structuring transactions, as well as tax controversy representation. He also continues to work advising governmental agencies in the area of abusive tax shelters. During his career he was responsible for and fully drafted tax opinion letters, memorandum and private letter rulings. He has not been primarily responsible for or participated in the compliance end of the accounting business by preparing tax returns, however he has assisted with specific tax return items. He is involved with the controversy stage of proposed adjustments to a tax return. He works with corporations and has considerable experience with Subchapter C Corporations and IRC §§301, 601, 357 and the judicial doctrines that impact these sections. He represents corporate clients before the IRS and the Tax Court and he has published.

5. Hamersley testified that Opinion letters must be prepared in accordance with Circular 230, which regulates the professional practice of federal tax practitioners before the IRS including attorneys, accountants and CPA‘s. Most of tax opinions he prepares are ―substantial authority" or ―should" confidence level opinions; which means that the transaction has a 70% or greater probability of success in the event of an audit. He testified that a ―more likely than not" confidence level opinion, which means there is only a 50.01% probability of success, requires an initial determination that the tax issue is a tax shelter pursuant to IRC §6662(e)(2)(c).

6. Hamersley testified that IRC §6662(e)(2)(c) defines tax shelter very broadly as any plan or arrangement with a substantial purpose of avoiding tax. What makes a tax shelter abusive comes generally from the application of judicial doctrines which determine if the substance of the transaction is consistent with its form. The judicial doctrines recast the transaction to comport with its economic substance. After extensive cross examination the court qualified Hamersley to

offer testimony as an expert in all areas for which he was presented. (See May 1, 2012, p. 91.) Hamersley's Report is marked as PX 1361.

7. Hamersley reviewed 41 documents in this matter to develop his opinion. (PX 1361). Hamersley testified that the August 2001 Tax Opinion Letters for Casuarina and Wytec are similar and for brevity he would answer questions with specific relating to Casuarina and the Lev301 transaction.

8. Hamersley testified that the engagement letter of September 5, 2000, identifies the opinions which Grant Thornton would provide regarding the Lev301. (PX 28). He testified that the five opinions listed on page two of this letter are substantially identical, but for the listing order, to the opinions contained in the December 28, 2000, opinion letter. (T. Test. p. 94). The December 28, 2000, opinion letter also added two opinions namely: (6) Judicial doctrines will not override opinions expressed on the aforesaid issues; and, (7) A shareholder or the Company will not be subject to any tax penalties in relying in good faith upon the opinions expressed on the aforementioned issues. (T. Test. p. 106). These two opinions do not appear in the August 13, 2001, opinions. (T. Test. p. 106).

9. He addressed Grant Thornton's three primary shareholder level opinion in the August 13, 2001, opinion. Namely:

> 3) The *Company's Shareholders* will recognize taxable income to the extent that the *Amount Distributed* under Section 301 is treated as a dividend. The *Amount Distributed* will equal the amount of cash received plus the fair market value of any property received. The fair market value of the property distributed is reduced by the amount of a liability encumbering the property. Here the *Bank Lien* exceeds the fair market value of the *Treasury Notes*. Consequently, the *Amount Distributed* that could be treated as a dividend is zero.
>
> 4) Upon payment by the *Company* of the obligation giving rise to the *Bank's* lien on the *Treasury Notes, Shareholders* will not be in constructive receipt of a distribution treated as a *constructive dividend.*
>
> 5) The tax basis in the *Treasury Notes* held by the *Shareholders* will be equal to the fair market value of the *Treasury Notes* at the date of the *Distribution*. The tax basis will not be reduced by any liabilities to which the *Treasury Notes* are subject. Section 301(d).

10. He described the Yung leveraged distribution as follows:

Step One: Purchase of Treasury Notes with RECOURSE Short Term Note and immediate transfer of custody of Treasury notes to Bank as Collateral in Company Custodial Account. These transactions occur either simultaneously or in immediate succession

1: December 29, 2000: The liability is created. Under IRC§301(b)(2) the Company borrows $23 million from the Bank payable solely by the Company to be used only to buy Treasury Notes which are to be the sole collateral for the loan and are limited to the use as collateral until the loan is paid. To complete Step 1.1 the money is deposits in a Company Custodial Account with the Bank.

2: Company uses the borrowed money to buy treasury bonds from the Bank and a pledge agreement-Bank Lien- is placed against the bonds to secure the borrowed money.

Step Two: The Company declares a Dividend of the Treasury Notes and Bank transfers to Treasury Notes to Shareholders Custodial Account. IRC§301 Dividend Distribution.

1: December 29, 2000: The Company declares a dividend distribution of $23 million of the Treasury Notes to the shareholders but ―subject to" the Bank lien (meaning the Treasury notes can only be used as collateral until the Bank lien is paid).

2: The Bank transfers the treasury notes from the Company Custodial Account to the Shareholders Custodial Account.

Step Three: Company Repays Short-Term Note/ Bank Lien Removed. The Company pays the $23 million from other assets in the foreign corporation and the Treasury Notes are released to the Shareholders debt free. The Foreign $23, million is transferred into the United States without any taxation and from the Company to the Shareholders without any taxation.

(A diagram of this transaction is attached as Appendix―B" to this judgment.)

OPINION ONE: THE CONCLUSIONS OF THE OPINION ARE NOT ACCURATE BECAUSE THE JUDICIAL DOCTRINES COLLAPSE THE TRANSACTION

11. Hamersley analyzed this Grant Thornton opinion regarding this leveraged distribution transaction as follows:

Hamersley testified that Grant Thornton did not address in their opinion how the loan encumbrance in the two tiers of Step One affected the IRC §301 dividend distribution described in Step Two. In other words Grant Thornton did not state why there was an actual distribution and receipt by the shareholders when the Treasury Notes were retained in the custodial accounts created to accommodate this transaction with control by the Bank, not the shareholders. He defined this as a ―transitory liability" and stated this is a matter of debate but was not addressed in the Opinion. (T. Test. p. 100).

12. Hamersley testified that in Step Two Grant Thornton's Opinion assumes that the transaction occurred, meaning that the custodial transaction really is an IRC §301 distribution because the company declared it to be a distribution. He discussed whether this is an actual or constructive receipt of a $23 million Treasury note by shareholders. He opined that it may be a future interest contingent on the completion of Step Three, the pay off of the bank lien, because the shareholders don't have anything in their hands to trade, borrow against or sell, or any authority to trade, borrow against or sell. At Step Three the shareholders will have something in their hands. The regulations dictate that you don't have the property until you have an unqualified right to it. Thus, this contingency may have prevented an actual distribution until Step Three. The court notes that in this interpretation there is no distribution, thus the analysis of Grant Thornton is flawed and/or any distribution would have occurred in Step Three which was after the January 4, 2001, regulations.

13. Step Three: Hamersley testified that Step Three was contingent as explained in reference to Step Two and did not have to occur because the company may have not paid off the loan, thus no actual or constructive dividend to the shareholders. He testified that if the distribution wasn't in the tax year 2000 because of his interpretation it would have been in 2001 when the bank lien was paid.

14. Hamersley testified that Grant Thornton's Step Three Opinion analysis that, at the time the debt is paid, the treasury notes are released to the shareholder debt and tax free is flawed because it ignores and fails to analyze the two tiers of Step One as a transitory liability.

15. Hamersley further testified that all of the judicial doctrines, which include substance over form, step transaction, business purpose, economic substance, and sham transaction, while differing in their applications, result in the same substantive recast of this transaction. He stated

that the judicial doctrines would either (1) disregard the transitory ―liability" created in Step One and extinguished in Step Three so that there exists no liability or encumbrance for purposes of IRC §301(b)(2)(B) in Step Two, or (2) disregard the company's ownership of the Treasury Notes to treat it as having purchased the Treasury Notes for the shareholders.

16. In other words the judicial doctrines would collapse the transaction to its clear components and thus the transaction would fail the judicial doctrines tests. Grant Thornton in the December 28, 2000, opinion letter expressed to a ―more likely than not" standard that the judicial doctrines would not override the Lev301 strategy and this opinion was omitted from the August 2001 opinion letter. (T. Test p. 108).

OPINION TWO: THE CONCLUSIONS OF THE OPINION ARE NOT ACCURATE BECAUSE IRC§301 (b)(2)(B) PRIOR TO JANUARY 2, 2001, WAS ***AMBIGUOUS*** *NOT UNAMBIGUOUS*

A. "Subject to" language of IRC §301

17. Hamersley testified that the conclusion of Grant Thornton that IRC§301(b)(2)(B) is unambiguous and that there is no need for reference to judicial doctrines for interpretation as Congress' plain meaning in the statute will be upheld is not accurate, even though this Grant Thornton opinion is supported from pages 8 through 33 with references to case law about the authority of the clear language of Congress.

18. Hamersley testified that IRC §301(b)(2)(B) is ambiguous which is proven simply because the court interpreted the words ―subject to" from the regulation in a case cited by Grant Thornton on page 21 of its opinion.

19. In the cited case, *Maher v. United States,* 69-1 USTC ¶9194 (W.D.Mo.) *("Maher I")*, the District Court addressed the issue of whether property distributed with respect to stock is subject to a liability for purposes of IRC §301(b)(2)(B). ―In *Maher I,* the property constructively distributed was subject to a blanket lien on the distributing corporation's assets. It thus satisfied

the statutory requirement under §301(b)(2)(B). However, the District Court held that the value of the distributed property would not be reduced by the liability because the property was not *in fact* subject to the liability." (GT Opinion p. 21). In *Maher I* a residence was: (1) part of a larger collateral pool of assets of which the residence was only 1% of the value, (2) as a result the lender had not looked to the residence as security for the loan, (3) as it was a small percentage of the assets there was no real risk of loss to the shareholder, and (4) additionally, the residence did not have a business purpose. Grant Thornton opined that this case is different from the facts of this transaction because: (1) the treasury notes are not a small percentage of the value of the collateral pool as there is no other property subject to the lien, (2) the bank looks to the distributed Treasury Notes as collateral and it is the only collateral, and (3) there is a real risk of loss to the shareholders because if the company experiences an adverse circumstance, even though the treasury notes are owned by the shareholders and are required to remain under the control of the bank in a custody account until the note is satisfied, they could be forfeited for payment.

20. In essence Hamersley testified that if there is a case that interprets this section of the code and it is contrary to the interpretation of Grant Thornton then by its very existence it presents an ambiguity.

B. "Immediately before and immediately after" language of IRC §301

21. Hamersley further stated that IRC §301(b)(2)(B) was ambiguous in that "immediately before and immediately after" language is not defined in the statute and there is authority, case law, and revenue rulings that define it differently. This means that the phrase is ambiguous and judicial doctrines, such as the "step transaction" doctrine, must be applied to the facts to determine if this language applies. The courts do not literally mean that you can have it for a

nanosecond; and while they differ about how long you have to meet the requirement, they agree it depends on all the facts and circumstances. (T. Test. p. 121, lines 13-19).

22. The courts have consistently stated that the ―immediately before and immediately after" requirement is not transitorily satisfied but is permanent. Hamersley testified this is important in the Lev301 and relevant in the Yung case because the encumbrance that is created in Step One and that is used to reduce the tax for the dividend distribution dies and is removed in Step Three. And so as the transaction must be analyzed to determine if it satisfies the ―immediately before and the immediately after" requirement, the test is not mechanical, thus making this language ambiguous. The courts agree and have not debated that ―immediately before and immediately after" is a substantive inquiry usually applied in a step transaction to make sure that the requirement in the statute is meaningfully and permanently satisfied. (T. Test. p. 122, lines 18-25; p. 123, lines 1-10).

23. Hamersley testified that because Grant Thornton determined that the language of IRC §301 was unambiguous they did not analyze the phrases of that regulation as is required by the interpretation in *Maher 1* and by the numerous authorities on the phrase ―immediately before and immediately after," which required application of the ―step transaction" judicial doctrine. (T. Test. p. 192).

24. Additionally, Hamersley testified that Grant Thornton failed to analyze the phrases ―received' or ―subject to liability" in IRC §301 which again confirms that there was ambiguity in IRC §301 sufficient for it not to be relied upon at a ―more likely than not" confidence level. (T. Test. pp. 125, 126).

OPINION THREE: THE CONCLUSIONS OF THE OPINION ARE NOT ACCURATE BECAUSE IRC§301(b)(2)(B) RESOLVED ANY "SUBJECT TO" AMBIGUITY THROUGH THE JANUARY 4, 2001, REGULATIONS

A. On January 4, 2001, the IRS issued a new regulation 1.301.1T(g)

25. This regulation resolves the ambiguity of the phrase ―subject to" in IRC §301 by defining when a liability is ―assumed," including when it is ―subject to," and when it is ―not." (T. Test. p. 127, lines 1-5).

26. Hamersley testified this IRS regulation did not change the prior analysis of a §301 transaction but eliminated any distinction between the ―subject to" and ―assumed by" language in the code. He stated that this new regulation was retroactive for transactions that are substantially similar to IRS Notice 99-59, commonly referred to as the BOSS notice. (T. Test. p. 148, lines 15-19).

27. Hamersley testified that the January 4, 2001, regulation made the determination of the type of liability, recourse and nonrecourse, a substantive issue as these types of liabilities are governed by two different sections of IRC §357. To determine if a shareholder has assumed responsibility for a liability and may use the liability to reduce the fair market value of the distribution, the nature of the liability must be determined. The nature of the loan is a matter of local/state law. Generally the recourse nature of the loan depends on the borrower's, and the company's, personal liability for the loan beyond the collateral. (T. Test. p. 128, lines 10-22). He testified that Grant Thornton was not qualified or authorized to make the decision as the recourse or nonrecourse nature of the loan; and, to do so would violate Circular 230. (T. Test. p. 30). Despite this, he stated that Grant Thornton assumed that the debt was nonrecourse in their opinion. He testified the opinion does not contain an analysis of this issue nor does it reference a law firm opinion relied on to determine the nature of the loan. (T. Test pp. 131-133). An opinion

relied upon on this issue would appear in the representation portion of the letter and be attached as an exhibit. (T. Test. p. 134).

28. Hamersley testified that IRC §357(d)(1) is broken down into (d)(1)(A) recourse loans and (d)(1)(B) nonrecourse loans. As a result the first task is to determine the type of loan being examined so the appropriate rule can be applied. To avoid taxation for a dividend distribution in a recourse liability scenario a shareholder is treated as assuming the loan for IRC §301(b)(2)(B) and reducing their taxable dividend if they are obligated and expected to pay the liability. He stated there is no debate in this case that the shareholders were not obligated or expected to pay the loan.

29. He stated that §6.2 of the pledge agreement (see PX 163 & 164) established personal liability to the CFC's, the borrower companies, in the event of a deficiency judgment should the collateral not be sufficient and if the loan was enforceable under local law as a recourse loan. In summary, if the loan was recourse and someone other than the shareholders was required to pay for any deficiencies the shareholders would not have assumed the liability. As a result the shareholders would not be able to reduce the dividend distribution of the $23 million Treasury notes by the $23 million debt of the December 29, 2000, loan. (T. Test. p. 134).

30. Hamersley testified that nonrecourse liability under §357(d)(1)(B) directs that when there is only a single asset securing the liability it is automatically deemed assumed, even if it has not been assumed by the shareholders. If the asset is transferred, the liability goes with it, and therefore the amount of dividend can be reduced.

B. Recourse or Nonrecourse affects Step two of the transaction

31. Hamersley testified one must first analyze the nature of the loan transaction between the borrower and the lender. Using local law, in this case Ohio, it must be determined for tax

purposes whether personal liability exists beyond the collateral by the borrower. If this first transaction, the borrowing as explained in Step One, is recourse then IRC §357(d)(1)(A) applies and if it is nonrecourse then IRC §357(d)(1)(B) applies. (T. Test. p. 144).

32. Hamersley testified, ―Based on the pledge agreement, from a tax perspective, assuming under local law, and I have no reason to believe that‘s not the case, that this document is a fully enforceable pledge agreement, it‘s recourse." (T Test. p. 144, lines 21-24). As a result, he concluded that this Lev301 transaction created a $23 million dividend as there is no reduction through liability assumed under IRC §357(d)(1)(a) because the shareholder neither agreed or were expected to pay on the loan. Thus, based on the January 4, 2001, regulation there was a zero percent chance that the shareholders would get a reduction and the distribution was fully taxable on December 29, 2000. Simply put, a loan does not change its character because there was a distribution.

C. "Similar or Substantially Similar to Notice 99-59, BOSS"

33. Hamersley testified that Grant Thornton inferred, but never articulated, that Lev301 was not substantially similar to a BOSS transaction, only that it was distinguishable. (T. Test p. 152). Hamersley testified that Notice 99-59, the BOSS transaction, identifies generally the tax situation in which a loan is acquired with collateral, where that loan is assumed in a distribution under IRC §301(b)(2)(b), this assumption is intended to reduce the amount of the distribution (dividend) and in the final step when the loan is released the full income (distribution/dividend) received is not included in income. (T. Test. p. 151, line 21 – p. 152, line 1). He testified that Notice 99-59 was not limited to the specific example in the notice and thus Lev301 is essentially identical to a BOSS transaction. The only difference between Lev301 and the example in Notice 99-59 is the set-up. The Notice 99-59 example has as the pass-through entity a partnership

established solely for the pass-through purpose instead of the Lev301 pass-through entity being an existing corporation. Additionally, the example triggers a benefit by liquidation as opposed to just payment of the loan. Otherwise, there is Step One an asset with a loan, Step Two the transfer of the asset with the loan and Step Three the payoff of the loan. (T. Test. p. 155).

OPINION FOUR: THE CONCLUSIONS OF THE OPINION ARE NOT ACCURATE BECAUSE GRANT THORNTON FAILED TO PROPERLY APPLY THE JUDICIAL DOCTRINE

34. Hamersley testified that the several judicial doctrines must be analyzed to assure that a tax shelter is not abusive. In his opinion Grant Thornton willfully, inadequately, and incorrectly applied these doctrines in its Lev301 opinions to the Yungs. (T. Test p. 157).

35. The ―substance over form" doctrine requires that a transaction not only comply with the literal terms of the statute but review of the entirety of the transaction and an examination of all the facts and circumstances must be undertaken to determine if the requirements of the statute and, further, the intent of Congress, has been met. (T. Test. p. 157).

36. The ―step transaction" doctrine applies to a transaction, such as the Lev301, where there are a series of transactions, to determine whether the series of transactions are part of a single integrated plan. (T. Test. p. 158). [See ¶10, supra, for Hamersley's explanation of the step transaction doctrine in the collapse of this transaction; see also Appendix ―B"] Hamersley referred to PX 42, June 2002, to show that Grant Thornton in the early stage of the development of Lev301 planned it not as a single integrated plan, but as a step transaction. (See ―The Product" ¶2; ―The Timeline" §I(B) ¶8 and §III(C) ¶32, *supra*, and T. Test. p. 160). The step transaction doctrine has three tests which are used in varying frequency by the courts. These tests are consequence driven and do not rely on tax motivation for their application, (T. Test. p. 165) and the Lev301 failed all three tests. The binding commitment test determines if there is a legal binding commitment to do one of the steps with the other. In the Lev301 the documents

themselves say not to do anything but distribute the shares, the documents are inextricably linked, intertwined, thus there is a binding commitment. The mutually interdependent test determines if all of the steps are to accomplish the result; in other words, would you not do one of these steps and not accomplish the distribution. The end result test simply asks whether you did all of this with the result in mind.

37. The most likely collapse of the Lev301, under the step transaction doctrine, is to eliminate the encumbrance, because the encumbrance is created in Step One, and is eliminated pursuant to the terms of the note in Step Three, a transitory liability. And the result, as there is no liability there, would be a single step transaction, distribution of $23 million of treasury notes unencumbered. (T. Test. p. 162).

38. These doctrines recast the Lev301 to show it is really a dividend distribution of $23 million in Treasury Notes to the shareholders. The encumbrance was not necessary and thus those steps do not have substance. (T. Test. p. 164). Hamersley testified that the part of the Grant Thornton opinion addressing the step transaction doctrine with its three tests is only two pages long with little analysis. (T. Test. p. 164).

39. Grant Thornton's Binding Commitment analysis merely states this test does not apply because there was no agreement as to any one transaction between the parties. The Mutually Interdependent analysis indicates that the parties could stop at any step, ―therefore, though not free from doubt, the taxpayers should be able to avoid the application of" this test. The End Result analysis states that as case law does not define a ―fixed and firm plan," and the existence of a plan alone does not justify application of the step transaction doctrine, thus the Lev301 strategy was nothing more than one would expect where a company decides to finance a distribution of an asset, thus this test should not apply. (*See* PX 163, pp. 67-68.). Hamersley

testified that this analysis was not only inadequate but the conclusions are incorrect. (T. Test. p. 164).

OPINION FIVE: THE CONCLUSIONS OF THE OPINON ARE NOT ACCURATE BECAUSE GRANT THORNTON KNEW OR SHOULD HAVE KNOWN THAT THE YUNGS' BUSINESS PURPOSE FOR THE TRANSACTION WAS NOT SUFFICIENT TO SUSTAIN OR AVOID THE APPLICATION OF A JUDICIAL DOCTRINE AND THUS WOULD NOT HAVE SUPPORTED THE OPINION

40. The business purpose doctrine is a prong of the economic substance doctrine which questions the primary purpose for the transaction to determine if it is just an alternative structuring of a business transaction or if it is a tax shelter. (T. Test. pp. 166-174). Hamersley testified that Grant Thornton's opinion merely discussed the business purpose doctrine and didn't present a true analysis of it. Additionally, he disagreed with Grant Thornton's conclusion that the business purpose doctrine applies to this Lev301 transaction. (T. Test. p. 166). Hamersley indicated that all of the documents he reviewed, including Grant Thornton's internal documents, support the premise that this was a tax motivated transaction not a business motivated transaction. (T. Test. pp. 167-171). He analyzed the transaction in terms of its business purpose to the Causuarina Company and stated that the transaction did not make the company more liquid but was intended to make the shareholders liquid, and shareholder business motivation is not relevant in a IRC §301 transaction. A business purpose looks to have a business advantage for a stated purpose. As this company did not need liquidity for business acquisitions it is not a profit motive. Additionally, the described purpose of hedging the Treasury Notes to offset the risk of other securities is implausible because the company only held the Treasury Notes for a nanosecond. He analyzed the transaction as one that doesn't have a stated business purpose for the company, Casuarina, but has an obvious business purpose to the shareholders who wanted to use the dividend distributions for a business acquisition. (T. Test. pp. 168-169).

41. Hamersley also testified that the arbitrage and profit reasons Grant Thornton stated as a basis for the business purpose is implausible as the costs of the transaction, including the $900,000.00 fees, are so large that recoupment would be very long term. (T. Test. p. 170).

42. Hamersley concluded that on December 29, 2000, and on August 13, 2001, the business purpose doctrine could not be sustained at the ―more likely than not" confidence level. (T. Test. p. 172).

43. Hamersley further testified that if the ―business purpose doctrine" prong of the economic substance doctrine fails, the analysis stops. While he could not find any facts of the companies' non-tax purpose to get past the subjective test of business purpose and get to the objective test of economic substance, (T. Test. pp. 174- 175), because the Grant Thornton Opinion undertook an analysis of the larger doctrine he offered testimony on this aspect of the opinion. He found there was no realistic expectation of the company achieving a reasonable profit for this transaction, and in fact the opinion did not project for profits. (T. Test. pp. 176 – 177). He also testified, for all the same reasons, application of the non-tax purpose test emphasizes that this transaction was undertaken only to distribute dividends to the shareholders without tax consequences and it was, therefore, a sham transaction. (T. Test. p. 177).

44. Hamersley rendered the opinion that Grant Thornton did not have sufficient authority to issue a ―more likely than not" opinion that the judicial doctrines would not apply to this transaction at the time of the engagement letter or any time thereafter. (T. Test. p. 179).

OPINION SIX: THE CONCLUSIONS OF THE OPINION ARE NOT ACCURATE BECAUSE A CONSTRUCTIVE DIVIDEND WOULD RESULT FROM THIS TRANSACTION

45. Hamersley testified that the purpose of the constructive dividend doctrine is a substance over form determination and the question is whether there is something the corporation does that confers an economic value on the shareholder that would constitute a distribution in substance. (T. Test. pp. 181-183). He testified that the Grant Thornton opinion analyzed this doctrine in an isolated and independent way by concluding that IRC §301(b)(2)(B) should be applied independently to Step Two, (the distribution), then §301(b)(2)(B) was applied independently to Step Three (the repayment of the loan) and then the case law (*Enoch v. Commissioner of Internal Revenue,* 57 T.C. 781 (1972)) applied in this independent manner would give a favorable result. He testified that it is improper to apply this test in isolation and the analysis did not include the totality of the circumstances of this transaction including the impact of the corporation's payment of the loan. (T. Test. pp. 181-182).

46. He also testified that the Grant Thornton opinion that this zero dividend to the shareholders would constitute a full basis value distribution and result in no gain upon subsequent sale of the Treasury Notes is not a correct conclusion. (T. Test. p. 188).

47. Hamersley concluded that the relevant tax authorities, including case law, in existence in 2000 and 2001 did not support Grant Thornton's ―more likely than not" opinion as to the stated tax consequences to the shareholders. (T. Test. p. 190). He also concluded that Grant Thornton's opinion was less than a ―reasonable basis" confidence level, which is twenty percent, and was probably frivolous after the January 4, 2001, BOSS regulations. (Trial Tr. 1510:2-1520:13 (Hamersley Test.)).

48. Additionally, Hamersley stated that Grant Thornton never had the adequate level of realistic possibilities of success for the income tax return preparer aspect of §10.34 of Circular

230. (T. Test. p. 196). Grant Thornton‘s failure to advise the companies of large fee promoter disclosure requirements and the list maintenance requirements, both initially and in response to the IRS, was behavior that did not comport with some of the disclosure requirements for clients pursuant to Circular 230. There was a very clear inherent lack of objectivity built into this transaction that disqualifies Grant Thornton from reasonable and objective analysis. (T. Test. p. 196). Hamersley stated, based on his review, in his opinion Grant Thornton failed to exercise due professional care when they advised the Yungs to enter into the Lev301 in 2000 in violation of Circular 230 §10.34 because they developed a strategy, came up with facts and then didn‘t support their conclusion with sufficient legal basis and authority. (T. Test. p. 203). In fact the December 28, 2000, letter, which contains opinions of Grant Thornton and was relied upon by the Yungs to proceed with the financing transaction and the dividend distribution (Step One and Step Two), did not contain any analysis. (T. Test. p. 203). Hamersley testified that the December 29, 2000, letter is referred to in the industry as a ―short form opinion” and can be relied upon. (T. Test. p. 206).

49. The interpretation and opinion by Grant Thornton created income tax reporting issues. Treasury regulation 1.60ll-4 identifies categories of reportable transaction that must be disclosed to the Internal Revenue Service. A subset of reportable transaction is a category called ―listed transactions.” He testified that Grant Thornton did not adequately advise the Yungs about the impact of the January 4, 2001, BOSS regulations on the Lev301 and this failure was a violation of Circular 230 §§10.20 to 22. (T. Test. p. 212). He testified that Grant Thornton should have advised the Yungs‘ and the Trust‘s Tax return preparer to report the income from the dividend distribution because there was no ―realistic possibility of success” for the return and this failure was a violation of Circular 230 §10.34. (T. Test. p. 213). He testified that Grant Thornton failed to

exercise reasonable professional judgment in the issuance of the opinions in December of 2000 and August of 2001. (T. Test. p. 215).

50. In summary, Hamersley testified that the judicial doctrines did apply to set aside the transaction and as a result the December 28, 2000, opinion did not meet the standard of ―more likely than not." He concluded that IRC §301 was ambiguous; that applying local law to the nature of the loan it was recourse; that, as the loan was recourse, there was no assumption of the liability by the shareholders, resulting in a distribution of dividends at the full value of $23 million; that Grant Thornton fell below the standard of care as they did not appropriately establish for their opinion the nature of the loan, and as the transaction was not complete by January 4, 2001, they misapplied the retroactivity of that regulation and the nature of the transaction. He also rendered the opinion that Grant Thornton was not correct, prudent or reasonable in rendering their Opinion; and that a competent, reasonable and prudent tax practitioner would have concluded that the IRS was likely to view the leveraged distribution transaction as an abusive tax shelter substantially similar to a listed transaction described in the BOSS notice. (T. Test. pp.193-195). Lastly, he testified that Grant Thornton's advice to not disclose the transaction or report the distribution was in violation of the tax code and Circular 230.

II. *FOR THE DEFENDANT: ETHAN YALE, ESQ.*

51. The Defendant called Ethan Yale, Esq., MBA, to offer his opinion on tax matters and tax professional responsibility. His general conclusions are:

1) Grant Thornton's advice was correct and competent;
2) Grant Thornton complied with the standards of tax practice when it rendered the advice;
3) He disagrees with Hamersley's evaluation and opinions regarding the transaction;
4) His opinion as to the effect and damages resulting from Plaintiffs' settlement with the IRS.

(T. Test. p. 107).

52. Yale graduated with a B.S. from Cornell University and a J.D. from Tulane Law School; he is not a CPA. (T. Test. Part 2 p. 5). He is a tenured professor at the University of Virginia Law School. He taught four years at U.V., four years at Georgetown University and two years at New York University. He currently teaches federal income tax including partnership, corporate, international, tax shelters and tax policy; He has taught IRC §301, §357, §611, §6112, §6662 and Notice 99-59 the BOSS transaction. He conducts seminars on tax shelters which include separation of legitimate from impermissible tax transactions, listed transactions, aggressive tax planning and limitations on aggressive tax planning, procedural rules such as disclosure and penalty rules, and standard of practice rules including Circular 230. He practiced for two years with a tax law firm in the areas of mergers, acquisitions, asset sales, corporate restructuring, spin offs, split ups, and other similar transactions. (T. Test. Part 2 p. 99). He never drafted an opinion solo, because he was not a partner, but he reviewed hundreds of opinions. (T. Test. Part 2 p. 100). He has published and has testified twice on tax strategies. (T. Test. Part 2 p. 103). He has an active consulting practice but he has not represented a client in a tax controversy or settlement before the IRS. (T. Test. Part 2 pp. 112, 113). He has given depositions in six cases, testified at trial in two cases and issued reports in at least nine cases. (T. Test. Part 2 page 33). In both trials he testified that taxpayers' transactions were not ―substantially similar" and those taxpayers were not successful at trial. (T. Test. Part 2 p. 36).

53. Yale stated he has an expertise in the substantive rules of law for participation in aggressive tax transactions and in the procedural rules that have resulted from aggressive tax planning, including list maintenance and registration, penalty rules and standards of conduct for professionals. (T. Test. Part 2 p. 101).

54. Yale defined “aggressive tax planning” as circumstances in which the taxpayer enters into a particular transaction where the law is unclear and they are trying to obtain a tax benefit. The law is unclear either because there is no law in the area or there are conflicting precedents and it is not apparent how a court will resolve the conflict. (T. Test. Part 1 p. 96). He testified it is not always clear when you‘re passing from a permissible to an impermissible transaction. (T. Test. Part 1 p. 102). Yale testified that a tax shelter is not a well-defined concept but most tax professionals understand it is a transaction entered into, at least in part, to generate tax benefits in circumstances where it‘s not clear whether those benefits are appropriate or not. It is another way to describe aggressive tax planning. (T. Test. Part 1 p. 130).

55. Yale reviewed depositions, IRS papers, and the IRS settlement, legal authority including the IRS Code and the Treasury regulations, case law authorities, revenue ruling, IRS notices, treatises, Circular 230, ABA Model Rules of Professional Conduct, and the AICPA Statement of Standards for Tax Services. (T.Test. Part 1 pp. 125-129).

56. After cross examination the Court qualified Mr. Yale to offer testimony as an expert in all areas for which he was presented. (T. Test. Part 2 p. 115).

57. Yale testified that the substance of the Yung Lev301 transactions are the two primary shareholder level opinions given in the August 2001 Grant Thornton opinion. Namely:

> 3) The *Company's Shareholders* will recognize taxable income to the extent that the *Amount Distributed* under §301 is treated as a dividend. The *Amount Distributed* will equal the amount of cash received plus the fair market value of any property received. The fair market value of the property distributed is reduced by the amount of a liability encumbering the property. Here the *Bank Lien* exceeds the fair market value of the *Treasury Notes*. Consequently, the *Amount Distributed* that could be treated as a dividend is zero.

Yale stated that this opinion, that the shareholders would not incur taxes as a consequence of the dividend distribution the Treasury Notes on December 29, 2000, is analyzed by Grant Thornton beginning on Page 8 of the August 2001 Opinion Letters. And,

> 4) Upon payment by the *Company* of the obligation giving rise to the *Bank's* lien on the *Treasury Notes, Shareholders* will not be in constructive receipt of a distribution treated as a *constructive dividend.*

(T. Test. Part 1 p. 142; PX 163 pages 2-3). The analysis for this opinion, that the shareholders are not going to have a constructive dividend when Casuarina and Wytec repay the First Star Bank loan, begins on page 34 of the August 2001 Opinion Letters. (T. Test. p. 142). Compare Hamersley ¶9, supra, who also emphasizes #5 as to the tax basis in the Treasury Notes.

58. Yale reviewed and analyzed the documents for both of the CFCs but for purposes of testimony referred primarily to those for Casaurina.

59. Yale describes the leveraged distribution as follows:

> THE FIRST TRANSACTION: On December 29th, First Star Bank lent to Casaurina and Wytec an aggregate sum of $30 million.
>
> THE SECOND TRANSACTION: The two companies used the loan proceeds from the first transaction to purchase Treasury Notes.
>
> THE THIRD TRANSACTION: The two companies distributed to the shareholders the Treasury notes, which are at that point collateral for the bank loan.
>
> THE FOURTH TRANSACTION: The two companies paid the First Star bank loan.

(T. Test. Part 1 p. 133, see Appendix ―C").

60. Yale views the December 28, 2000, letter as merely an explanation regarding an opinion that is to be issued in the future, not as the opinion itself described by the September 2000 engagement letter. (T. Test. Part 1 p. 123). He implied but did not directly state that the Yungs should not have relied on the letter as an opinion. (T. Test. Part 2 pp. 174, 190).

61. In Yale's opinion the arguments in favor of the taxpayers' position as analyzed in the August Opinion Letter are stronger than the arguments opposing the taxpayers'

position based on the facts as he understood them. Therefore, the taxpayer is more likely than not to prevail. (T. Test. p. 148).

OPINION ONE: THE CONCLUSIONS OF THE OPINION ARE ACCURATE BECAUSE THE JUDICAL DOCTRINES DO NOT COLLAPSE THE TRANSACTION

62. In Yale's opinion Grant Thornton properly considered the judicial doctrines and how they bear on the analysis of this case. (T. Test. Part1 p. 117). He testified that the principal ―substance over form" judicial doctrine is the ―step transaction" doctrine, and explained that these doctrines are used to understand, from a tax standpoint, the commercial relationship in the transaction. The step transaction doctrine might, for example, take formerly distinct Step A and Step B and combine them together to view the amalgamated whole transaction rather than the discrete constituent parts. (T. Test. Part 1 p. 185). He testified that application of this doctrine to the Yung transactions would consolidate the loan in December 2000 with the loan repayment in October 2001. The collapse into a single event means there is no loan and thus no reduction under §301(b)(2)(B). (T. Test. Part1 p. 190).

63. Yale did not think it likely that this doctrine would apply because the Yungs said they were not motivated by tax-avoidance reasons and the steps were not in rapid-fire sequence, (T. Test. Part 1 p. 191), and a collapse of the transaction leaves outside the step transaction the fact that interest was earned and paid. Additionally, he considered that the borrowing companies could have gone bankrupt or other possible risks could have occurred to change the transaction. (T. Test. Part 1 p. 191). He testified that his opinion is contrary to Hamersley's and the IRS' because in his opinion the separation of ten months for the repayment of the loan and the commercial motivation prevents the collapse of the Lev301 into one transaction. (T. Test. Part 1 p. 193).

64. In Yale's opinion the collapse of the first transaction, which is First Star Bank lending Causarina and Wytec an aggregate of $30 million on December 29th, into the second transaction, the use of the loan proceeds from the first transaction to purchase Treasury Notes, which is also collapsed into the third transaction, the two companies distributing the collateralized Treasury notes to the shareholders, does not result in a dividend distribution of the aggregate $30 million because the collapse is negated by the separation of ten months from the fourth transaction in which the two companies pay the First Star Bank loan. (Hamersley Opinion One ¶¶11-14, ―transitory liability," *supra*).

OPINION TWO: THE CONCLUSIONS OF THE OPINON ARE ACCURATE BECAUSE IRC §301 PRIOR TO JANUARY 2, 2001 WAS UNAMBIGUOUS

65. Yale testified that when there is a distribution in kind, meaning property other than money, you have to decide the value to assign to that asset. To begin this analysis you look to IRC§301(b)(1) which requires that a fair market value is assigned to the property. If there is a liability attached to the distribution it must be analyzed using the next subsection, IRC §301(b)(2). This subsection provides for a reduction of the fair market value of the property for liabilities. (T. Test. Part 1 p. 151).

66. To determine whether the value of the property can be reduced by the liability it is necessary to look to the alternative rules in this subsection. IRC §301(b)(2)(A) says that a reduction to the fair market value of the property is made for any liability that is ―assumed" by the shareholder. Yale testified there was no dispute between the experts that the shareholder did not assume the First Star Bank loan or pledge their personal assets as collateral, so that section does not apply. (T. Test. p. 152). IRC §301(b)(2)(B) says the amount of any liability is that amount to which the property received by the shareholder ―is subject" ―immediately before and immediately after" the distribution. He testified that he agreed with the Grant Thornton analysis

that this rule is applied mechanically because there is no language in that section of the Code requiring the consideration of the taxpayer‘s purpose or motive. He testified that Grant Thornton‘s opinion was accurate that in this transaction the value of the distribution in encumbered notes to the shareholders has a value of zero. (T. Test. p. 152).

67. Yale testified that the *Maher* case is the one and only case with potential relevant judicial authority on IRC §301 (b)(2)(B). (T. Test. Part 1 p. 154). In his opinion, which is the same as Grant Thornton‘s, *Maher I* had no application to the Yung Lev301 because it is factually distinguishable. Yale explained that in the *Maher* case a corporation had over-collateralized a loan by a factor of two. An asset, a house, was removed as part of the collateral for the loan and was distributed without debt to the shareholders. The corporation did not report the asset transfer as a dividend distribution. The Court held in *Maher I* that because the asset was part of the over-collateralization and wasn‘t really needed to secure the loan the dividend distribution did not carry a liability with it and therefore the dividend distribution was taxable. (T. Test. Part1 p. 156). Yale testified that the Yung Lev301 transaction is different because the value of the Treasury Notes are the same value as the liability and thus clearly act as the collateral security for the First Star Bank loan. He concluded that because of the stark factual difference, from a commercial standpoint, in his opinion *Maher I* does not sheds any light on how the court would apply IRC§ 301(b)(2)(B). (T. Test. Part 1 p. 157). Yale did not agree that an interpreting case of this regulation by its very existence establishes an ambiguity. (T. Test. Part 2 p. 54).

- **"Subject…Immediately Before and Immediately After"**

68. Yale testified that while there is no other case law in this area to interpret the ―subject immediately before and immediately after" language of IRC§301 this language was repeated nearly verbatim in IRC §357(c)(1) prior to its 1999 modification. He stated that while IRC

§357(c) addresses transactions in which shareholders contribute property to a corporation the courts will look to other code sections for interpretation. (T. Test. Part 1 p. 157).

69. Yale further testified that he referenced the pre-1999 language of IRC §357(c)(1) which included the phrase ―liabilities to which the property is subject" because they are of the same tenor as the current IRC §301 language. Using a photo slide to demonstrate his argument, Yale analogized a §357 transaction, in which a shareholder who is personally liable on a debt transfers the property that was security for the debt to the corporation and the corporation does not assume the debt, to a §301 transaction. (T. Test. Part 1 p. 159; slide 6; Appendix ―D"). Yale stated that the relevant court authority held that even though the shareholder was still responsible for the debt and the corporation, which now owned the asset, was not responsible for the debt that the property was still subject to the debt in the relevant sense that the language was used in IRC §357(c)(1). (T. Test. p. 159). He testified using the parallel reasoning of this case to analyze the Yung Lev301 results in a finding that the Treasury Notes transferred to the shareholders are subject to the liability and thus the value of the Treasury Notes is zero. (T. Test. p. 159; see, *Owen v. Commissioner of Internal Revenue,* 881 F.2d 832 (9th Cir. 1989); *Beaver v. Commissioner of Internal Revenue*, 41 T.C.M. 52 (Tax Ct. 1980); *Rosen v. Commissioner of Internal Revenue*, 62 T.C.11 (Tax Ct. 1974); IRS Technical Advice Memorandum 9640001 (October 4, 1996); Slide 6). Yale presented his opinion that this interpretation of former IRC §357(c) was important to the ―more likely than not" conclusion regarding a Court's interpretation of IRC §310. (T. Test. Page 2 p. 56). On cross-examination,Yale agreed that *Maher 1* did not bolster the statutory construction argument so Grant Thornton looked to the case law of former IRC §357(c). (T. Test. Part 2 p. 58).

70. Yale testified that IRC§357(b) – Tax avoidance purpose – is the opposite of a mechanical rule in IRC§301(b). (T. Test. Part 1 p. 153). IRC§ 357(b) requires that the taxpayer's purpose or motivation be analyzed in arriving at the legitimacy of the business transaction, thus it is necessary to look at the taxpayer's subjective motivation whereas the language in IRC§ 301(b) only requires that the objective facts be analyzed. (T. Test. p. 152).

OPINION THREE: THE CONCLUSIONS OF THE OPINION ARE ACCURATE BECAUSE THE JANUARY 4, 2001 REGULATIONS WERE INVALID AND WERE NOT RETROACTIVE TO THE EFFECT OF IRC §301 ON THIS TRANSACTION

A. On January 4, 2001, the IRS issues a new regulation 1.301.1T(g)

71. Yale indicated the January 4th regulations are addressed at pages 20 through 34 of the Grant Thornton opinion. In Yale's opinion Hamersley gave too much "weight or providence" [sic] to the temporary regulations in the outcome of the matter between the Yungs and the IRS and he was incorrect in doing so. (T. Test. Part 1 p. 117). The temporary regulation section reads: "For purposes of IRC §301, no reduction shall be made for the amount of any liability unless the liabilities assumed by the shareholder are within the meaning of §§357(d)(1) and (2)." (T. Test. p. 172).

72. Yale testified that the January 4th regulations didn't apply to the Yungs' Lev301 transactions as advised by Grant Thornton because in his opinion these regulations are invalid as in conflict with the statute and, by their terms, these regulations only have retroactive application in a limited number of cases which do not include this Lev301. (T. Test. Part 1 p. 162).

73. Yale opined that if it is assumed for the sake of argument that the January 4th regulations apply to this transaction then Grant Thornton's Opinion is still correct. He testified the regulation requires the liability must be "assumed" by the shareholders within the meaning of IRC §357(d)(1) and (2) – Determination of amount of liability assumed – to reduce the value of the liability from the value of the IRC §301 dividend distribution to a shareholder. He testified that

in his opinion this liability was assumed by the shareholders because the liability was nonrecourse as to those shareholders. (T. Test. Part 1 p. 163).

74. Yale testified that IRC §357(d)(1)(A) is the provision which directs the application of recourse liability and IRC §357(d)(1)(B) is the provision which directs the application of nonrecourse liability. He testified §357(d)(1)(A) requires a shareholder in a recourse transaction to agree to and be expected to satisfy the liability in order for the liability to be subtracted in measuring the taxable dividend to arrive at a zero result. (T. Test. Part 1 p. 164).

75. He testified that in both his and Grant Thornton's opinions the pertinent language concerning Yung's transaction is that of IRC §357(d)(1)(B) which directs that a nonrecourse liability is treated as having been ―assumed" by the transferee of an asset subject to an encumbrance. Thus the distribution of the Treasury Notes pursuant to this regulation would be zero as IRC §357(d)(1)(B) is essentially the same as IRC §301. (T. Test. Part 1 p. 165). Yale testified that while IRC §357 generally is not a mechanical rule, and that while IRC §357(b) demands that you take into consideration a taxpayer's purpose, §357(d)(1) on its face does not ask the reader to consider the taxpayer's purpose. He concludes as there is no requirement on the face of IRC §357(d)(1) there should be no consideration of the taxpayer's purpose or motivation. He concludes that even though IRC §357 is not a mechanical rule as the plain meanings of §357(d)(1)(A) and (B) are being used in the interpretation of IRC §301, a mechanical rule, that the purpose or motivation of the taxpayer is not considered. (T. Test. Part 1 p. 171).

B. Recourse or Nonrecourse

76. Yale testified that the question of whether a loan was recourse or nonrecourse is a tax question. (T. Test. Part 1 page 166). As a result, for the purpose of application of IRC §357, it is the posture of the shareholders that must be determined, not that of the company. Yale testified

that the Yungs' Lev301 transaction is a hybrid recourse/nonrecourse debt from a commercial standpoint as opposed to from a technical IRC §357(d)(1) standpoint. (T. Test. Part 1 p. 167; Part 2 p. 154**).** The court finds at a minimum that this interpretation admits there is an ambiguity in the application of IRC §357 to IRC §301.

77. He testified and agreed with Hamersley that the First Star loan is a recourse loan as to the company. In his opinion the references in IRC §357 are to the transferee, in this case the shareholders, and thus the analysis of the liability should be focused on applying the regulation to the characterization of the transaction's nature to the taxpayer. (T. Test. Part 1 p. 167). He cited several cases, including *Crane v. Commissioner of Internal Revenue,* 331 U.S. 1 (1947), and *Commissioner of Internal Revenue v. Tufts*, 461 U.S. 300 (1983), for the proposition that the Courts are only concerned with the taxpayer's position regarding the recourse or nonrecourse nature of the loan with the lender. (T. Test. Part 1 p. 168).

78. Yale interprets the law to indicate that courts are not concerned with who the lender has recourse against if it is not the taxpayer/shareholder. Yale testified this conclusion is supported by IRC §732, a partnership revenue tax code provision, which defines a nonrecourse debt as a loan for which no partner bears an obligation of repayment. It does not say a nonrecourse loan is one for which no one bears the obligation of repayment. (T. Test. Part 1 p. 169). Yale also cited IRC §465(b)(4), at-risk rules, as authority that the courts do not look to see if there is recourse to some other party in the universe. In Yale's opinion based on these analogous settings a court confronting this language would ―most likely" conclude that the loan at issue here is nonrecourse to the shareholders, and that is what matters. It does not matter that there is recourse to the companies. Therefore in Yale's opinion the January 4th temporary regulation did not apply to

this transaction because the loan was nonrecourse to the taxpayer shareholders. (T. Test. Part 1 p. 169).

79. In Yale‘s opinion Hamersley exaggerated the importance of the recourse/nonrecourse issue. He views it as one discrete part of the analysis in the application of IRC §357. However, on cross-examination Yale agreed that paragraph (g) of the January 4, 2001, regulation states, ―No reduction shall be made for any liability unless the liability is assumed by the shareholders within the meaning of §357(d).” (T. Test. Part 2 p. 139).

80. Yale references ―The Regulation” analysis on page 20 paragraph 3 of the Grant Thornton opinion as Grant Thornton‘s determination that IRC §357(d)(1) and (2) are clear on their face. He testified that the last sentence of the paragraph discusses the actual application of this section. That sentence reads: ―The ‗treated as‘ language clearly acknowledges that the liability is not one which has not been actually assumed under state law.” This language in the Grant Thornton Opinion suggests to Yale that this is a clear provision and its application to this case is unambiguous. (T. Test. Part 2 p. 130). However, he agreed on cross that Grant Thornton did not say that IRC§357 was clear on its face as to the determination of a ―recourse” or ―nonrecourse” liability, or as to the meaning of ―treated as.” (T. Test. Part 2 p. 131).

81. Yale explained that a recourse liability doesn‘t necessarily encumber the property. Just because an obligor has a liability it doesn‘t automatically follow that there is a security involved. (T. Test. Part 2 p. 134).

82. Yale testified that IRC §357(d)(1)(A) does not mention a security interest of any type so the important thing to its application is only whether the transferee agrees to and is expected to satisfy the liability. Yale agreed on cross examination it is not clear that §357(d)(1)(A) works as an automatic assumption of recourse debt because it says, ―the transferee has to agree to and be

expected to satisfy the liability.” (T. Test. Part 2 p. 139). The court finds this to mean that at the very least IRC §357 is ambiguous.

83. On cross-examination Yale was referred to PX 943-R (PX 122-R), the June 27, 2001, memorandum authored by Cohen, a tax lawyer who had reviewed the Lev301 proposal for another client. (See Timeline §VI(F) ¶197, *supra*.) Yale disagreed with the premise of the Cohen memorandum that you look to the distributing entity to determine the nature of the transaction. (T. Test. Part 2 p. 152). Yale agreed with Hamersley that in a pure nonrecourse loan, with no recourse to the distributing entity or to the transferee, IRC §357(d)(1)(B) is interpreted to mean that when that property subject to the nonrecourse liability is transferred there is no transfer of personal liability so it is ―deemed assumed.” (T. Test. Part 2 p. 152). He disagreed with the premise that the loan should not be treated as assumed by the shareholders in this hybrid situation where the loan is recourse to the distributing entity and the shareholders merely take the asset subject to the debt without personal liability. (T. Test. Part 2 p. 151).

84. Yale stated that the company and the shareholders did not have a written agreement that the company was obligated to repay the Bank Note; this is confirmed by the #14 representation by Yung in the Opinion Letter. (PX 163, page 7: ―Rep #14 – No guarantee or any other agreement of any other type exists between the *Company* and the *Shareholder*s with regard to the *Company's* obligation to the *Bank* under the note”). Yale agreed on cross examination that Notice 99-59 did not require an ―understanding” pursuant to the Notice to be in writing. Yale did not testify there was no ―understanding” with the shareholders only that there was no ―agreement” with the shareholders. (T. Test. Part 2 p. 107).

85. Yale said that a note creates the obligation and ability for the lender to enforce payment; (T. Test. Part 2 p. 116) and that a ―lien” refers to the creditor's standing as a secured party, which

might derive from the note or from another document. A lien can also be a security interest and notification that the collateral is subject to an obligation. (T. Test. Part 2 p. 112).

86. Yale acknowledged on cross-examination that in this case the IRS only looked to the taxpayer to interpret the nature of the loan when they determined, ―Although these documents include pledge agreements, notifications and control agreements, including addendum, the documents do not transfer First Star‘s right to enforce payment from the CFCS." (PX 1431; T.Test. Part 2 p. 168). Yale agreed that the IRS concluded that the transaction fails the provision of a recourse loan under Section IRC §357(d)(1). In other words because the corporations did not pass the obligation to repay the debt to the shareholders they did not ―assume" the liability and thus the shareholders received a full value dividend distribution. (T. Test. Part 2 p. 168). The court finds this is in conformity with Hamersley‘s first opinion that the Lev301 transaction failed before the publication of the January regulations.

C. "Similar or substantially similar" to Notice 99-59, BOSS

87. Yale testified that Notice 99-59 did not use the words ―substantial" or ―similar" and the January 4th regulations which first used these words did not define them. (T. Test. Part 1 p. 176).

88. Yale stated that Notice 99-59 described as the first step in the transaction the formation of a new and third party entity not the involvement of an established and first party entity. (T. Test. Part 1 p. 173). He explained the second step is the borrowing of the money and the use of that money to buy securities. He stated the third step is that the investment securities subject to the bank lien are distributed to the taxpayer. ―Everyone knows that the new foreign corporation will actually repay the loan." The taxpayer then sells their stock in the corporation for the prior value minus the amount of the loan which is zero and they generate a loss and they set it off against unrelated income. (T. Test. Part 1 p. 174). Yale testified that the Notice 99-59 example addressed

the generation of a capital gain/loss which can be used to set off capital gains from unrelated transactions and this is a different tax consequence than avoiding dividend income. (T. Test. Part 1 p. 175; see Appendix –E”).

89. In Yale‘s opinion, Grant Thornton‘s case law supports the idea that small but significant material distinctions between one thing and another are sufficient to show there is no substantial similarity. Notably there was a third part to the transaction, the corporation was a substantial permanent entity, not one created for the transaction, and the transaction was to transfer assets not to generate a loss. (T. Test. Part 1 p. 176). He noted that later in 2002 when the definition was issued which included –the transaction produces the same or similar tax consequences” this product would still not be a loss. (T. Test. Part 1 p. 178).

90. Yale testified that the Grant Thornton Opinion Letter at page 72 states that Notice 99-59 regulates the distribution of encumbered property and so to that extent the transaction is similar. However, Grant Thornton suggested, and he agreed, that the Notice 99-59 transaction was **distinguishable** because it involved a series of contrived steps that went beyond the facts of this Lev301. Notice 99-59 involved a formation of a transitory entity. In his opinion if Grant Thornton believed that the transaction was **distinguishable**, as stated on page 72, then the transaction was **not similar or substantially similar** to the Notice 99-59 transaction. The similar or substantially similar nature of the transaction is the condition necessary for retroactive application. He agreed that designating a transaction as distinguishable is a different formulation than the determination that the transaction is –substantially similar.” (T. Test. Part 2 p. 100). He agrees that this Grant Thornton opinion that the transaction was not similar or substantially similar was not given at a –more likely than not” confidence level.

91. Yale testified that he agreed with Grant Thornton‘s conclusion in J. Michel‘s January 10, 2001, e-mail to the Yungs that ―We are of the opinion, as of today, that these reg‘s do not adversely affect your two transactions as they were finalized prior to the effective date." (T. Test. Part 1 p. 179).

D. The January 4, 2001 regulations are not retroactive

92. Yale noted that this transaction occurred on December 29, 2000, before the passage of the regulations. (T. Test. Part 1 pp. 142, 172). Additionally, Yale testified that the Lev301 transaction was not ―substantially similar" to a Notice 99-59 BOSS transaction as described above. Therefore he determined that the January 4, 2001, regulations had no retroactive application to the Yung transaction. Yale testified that Grant Thornton never analyzed whether the regulation was retroactive nor concluded it was retroactive (T. Test. Part 2 pp. 95, 109), but that Grant Thornton assumed the January 4, 2001, regulations were retroactive and then concluded it did not change the result. (T. Test. Part 1 p. 196).

OPINION FOUR: THE CONCLUSIONS OF THE OPINION ARE ACCURATE BECAUSE GRANT THORNTON PROPERLY APPLIED THE JUDICAL DOCTRINES

93. In Yale‘s opinion Grant Thornton properly considered the judicial doctrines and how they would bear on the analysis of this product. (T. Test. Part 1 p. 117). Yale testified that the Grant Thornton Opinion discussed all the potentially relevant judicial doctrines beginning on Page 53 of the Opinion. (T. Test. Part 1 p. 145). The economic substance doctrine, the sham transaction doctrine and the business purpose doctrine stand for the proposition that, even if a taxpayer‘s transaction is technically compliant with the literal rules, these doctrines collectively displace the statutory and regulatory rules and deny taxpayer‘s results that are too good to be true if the necessary things are established to their application. (T. Test. Part 1 p. 184).

94. Yale testified that there are other doctrines that fall under the umbrella of economic substance with the principal one being the step transaction doctrine. These are fact-finding doctrines. (T. Test. Part 1 p. 184). He believes that all of the judicial doctrines are relevant and they were discussed by Grant Thornton. (T. Test. Part 1 p. 185). The court has addressed Yale‘s opinion on the step transaction doctrine under “Opinion One” of this section.

95. Yale testified that the economic substance doctrine asks, “Did the transaction have objective economic effect?” And if so “Was the taxpayer primarily motivated by tax avoidance?” In Yale‘s opinion this test does not apply to the Yung Lev301 because the Firstar Bank loan was outstanding for ten months and interest accrued in the bank‘s favor. However, as applied it does not change the Lev301 as the interest was paid by the company; the Treasury Note interest was received by the shareholders; and the parties were at credit risk, thus the transaction was commercially real and it changed the economic stake for all involved. (T. Test. Part 1 p. 187). Having determined that there was economic substance to the transaction the next step is to determine if the taxpayer has an adequate business purpose for entering into the transaction. (T. Test. Part 1 p. 188).

OPINION FIVE: THE CONCLUSIONS OF THE OPINION ARE ACCURATE BECAUSE THE YUNGS' BUSINESS PURPOSE FOR THE TRANSACTION WAS SUFFICENT TO SUSTAIN OR AVOID THE APPLICATION OF A JUDICAL DOCTRINE AND THUS SUPPORTS THE OPINION

96. Yale testified, from his review of all the documents, that the Yungs were motivated by four different non-tax business purposes. These included (1) having liquidity for working capital to undertake renovation and construction projects; (2) repatriating funds to purchase Lodgian; (3) using lending opportunities to form new working relationship with lenders, which is important as the Yungs‘ business is capital intensive; and (4) borrowing money at a floating rate to make a fixed rate investment in Treasury Notes, so it was an interest rate bet. (T. Test. Part 1 p. 189).

97. In Yale's opinion Hamersley is not an appropriate individual to make credibility judgments regarding the taxpayers' motive for entering into the transaction. The Yungs offered several credible business purposes which motivated them to undertake this transaction, and these business purposes were plausible, so Grant Thornton was entitled to rely on them. (T. Test. Part 1 p. 118).

98. Yale agreed there was no representation by the taxpayer that their primary motivation to enter into this transaction was non-tax related. (T. Test. Part 2 p. 178). He agreed the initial outline of this transaction from J. Michel reflects that the last step of the transaction requires that the securities are sold or held to maturity by the shareholders. (T. Test. Part 2 p. 182). Yale did not consider this step but indicated it should not have had any impact on the transactions even though it reflects the knowledge of Grant Thornton concerning the motivation of the Yungs. (T. Test. Part 2 p. 183).

99. Yale said that, while Hamersley opined that there was no business purpose, the taxpayers told the IRS in their filings that there were business purposes and that they were motivated by those business purposes so that has to be true. Therefore, either the Yungs lied to the IRS, which would be a crime, or Hamersley is wrong. (T. Test. Part 2 p. 204). Yale fails to acknowledge that the promotion by Grant Thornton of the Lev301 product was tax avoidance motivated. Additionally, he fails to acknowledge that the Yungs were never told their business purpose was not sufficient, and that Grant Thornton continued to inflate the business purpose without informing Yung of the reasons for so doing.

OPINION SIX: THE CONCLUSIONS OF THE OPINION ARE ACCURATE BECAUSE NO CONSTRUCTIVE DIVDEND RESULTED FROM THE TRANSACTION

100. Yale testified that a constructive dividend occurs when there is no declaration of a dividend but from the substance of the corporate action it is obvious to everyone that what is

really happening is the corporation is constructively paying a dividend to its shareholder. (T. Test. Part 1 p. 181). Constructive dividends are addressed in voluminous case law. (T. Test. Part 1 p. 182). Yale's opinion is that it is ―more likely than not" that a court would decline to apply this doctrine to the Yung Lev301. He acknowledged that it was possible the doctrine could apply but he explained that he thought it unlikely. (T. Test. Part 1 p. 182). He testified that Grant Thornton cited cases to support this proposition. (T. Test. Part 1 p. 183). Yale testified that the cases that apply the constructive dividend doctrine do not focus on the nature of the loan as recourse or nonrecourse.

101. Yale testified that Grant Thornton's opinion number three that the value of the encumbered asset transferred as a dividend was reduced by that encumbrance to the value of zero, and opinion number four that the payment of the encumbrance by the company would not result in a constructive dividend to the taxpayers address two different issues. (These opinions from the August 2001 Opinion can be found at PX 163 pages 2-3 and are also set forth above in Yale's Opinion One ¶57.)

102. Yale testified on direct examination that in accordance with opinion number three the shareholders would not incur taxes as a consequence of dividend distribution of the Treasury Notes on December 29, 2000. (T. Test. Part 1 p. 142; Part 2 p. 47). Yale acknowledged on cross-examination that a constructive distribution, <u>if any</u>, would occur on the date of the loan repayment. (T. Test. Part 2 p. 48). These are two different events and a payment in October 2001 would not relate to a dividend distribution in December 2000. (T. Test. Part 2 p. 48).

OPINION SEVEN: GRANT THORNTON COMPLIED WITH THE STANDARDS OF TAX PRACTICE WHEN IT RENDERED THE ADVICE

103. Yale testified that Grant Thornton considered every material federal income tax issue and analyzed it thoroughly. They consider authorities that were both supportive and contrary to their

opinion. (T. Test. Part 1 pp. 116, 133, 134). Yale testified that the IRS doesn‘t cite any new law in its report but instead disagrees with Grant Thornton‘s interpretation of the law. (T. Test. Part 1 p. 134). As a result he concludes that their opinions were complete.

A. More Likely than Not

104. Yale concluded that Grant Thornton reached an appropriate conclusion and the analytical path they used to reach their decision was sound so the substantive conclusion was correct. (T. Test. Part 1 p. 117). Yale testified that on December 29, 2000, Grant Thornton had not finalized their research regarding the tax consequences of the Yung Lev301 because of the January 4, 2001, regulation. He had no opinion as to whether Grant Thornton had completed their research regarding the viability of the transaction. (T. Test. Part 2 p. 190).

105. In Yale‘s opinion the full context of the Grant Thornton Opinion is at a confidence level of ―more likely than not.” (T. Test. Part 2 p. 169). He testified that a ―more likely than not opinion” means that the arguments against the taxpayer are real, meaningful, things where the IRS might or perhaps is likely to conclude that the invalidity of the transaction is worth taking to court. (T. Test. Part 1 p. 140). Yale testified that all participants to a ―more likely than not” opinion understand this means that your financial adviser is not sufficiently confident to give you a ―will” or ―should” opinion. (T. Test. Part 1 p. 137). So when a party enters into a transaction that is associated with a more likely than not opinion, implicit in the decision to go forward is ―an understanding that there are real serious, considerable, nontrivial, meaningful, substantial arguments for invalidity.” (T. Test. p. 140).

106. Yale testified that ―more likely than not” opinions are usually given in the context of tax shelter transactions and aggressive tax planning, areas and circumstances in which the IRS is likely to invoke judicial doctrines. Hamersley agreed with this premise. Confidence levels

decrease from a ―will” or ―should” opinion to a ―more likely than not” opinion in circumstances where the IRS is likely to invoke judicial doctrines because judicial doctrines are inherently imprecise. And predicting how a court would resolve the application of those doctrines is less certain than predicting how a court would resolve the application of more cut-and-dried rules in the statute. (T. Test. Part 1 p. 140).

107. Yale agreed with Grant Thornton‘s statement regarding statutory construction, ―Thus, in our opinion, a court should **not**, as a matter of law, reach beyond the statute to any of these judicial doctrines if the effect is to add limitations or criteria that a taxpayer must satisfy where they are not already included on the face of §301(b)(2)(B).” (Emphasis added.) Yale testified that a ―should” opinion is given at a 70% confidence level. In his opinion the attorney cross-examining him made a gross mischaracterization of the Grant Thornton Opinion by saying that the use of the phrase ―should not” in this one statement meant that it was given at the ―should” confidence level and it does not actually increase the level of confidence of the entire opinion. (T. Test. Part 2 p. 169). The overall confidence level of the Opinion is ―more likely than not.” (T. Test. Part 2 p. 170).

108. The statutory construction opinion was based on the clear and unambiguous language of the mechanical test of IRC §301 which Yale agreed was interpreted with the subjective test and the ambiguous language of IRC §357.

109. Yale agreed on cross-examination that Grant Thornton in its December 28, 2000, Opinion letter stated to a ―more likely than not” confidence level that judicial doctrines will not override opinions expressed on the aforementioned issues. (PX53, T. Test. p. 175).

110. Yale also agreed on cross-examination that the Grant Thornton Opinion never stated that the judicial doctrines would not override the offered opinions at any confidence level including

―more likely that not" in its determination that the judicial doctrines will not override the opinions offered. (T. Test. Part 2 p. 170). Yale testified that while Grant Thornton did not make that specific statement, they could have said it, as it was discussed ad nauseam in the opinion and it quite clearly conveyed a ―more likely than not" opinion to the ultimate outcome of the case. (T. Test. Part 2 p. 175).

111. In Yale's Opinion there is an overall conclusion of correctness of the Grant Thornton Opinion based on the use of the right analytical paths and the sufficiency of the authorities citied in the Opinion. (T. Test. p. 194).

112. It was Yale's Opinion that the arguments in favor of the taxpayers' position as analyzed in the August Opinion Letter are stronger than the arguments opposing the taxpayers' position based on the facts as he understood them. Therefore, the taxpayer is more likely than not to prevail. (T. Test. Part 1 p. 148).

B. List Maintenance

113. A listed transaction is a transaction that the IRS has actually listed and stated that the taxpayer will not be granted the tax benefits that flow from the transaction. (T. Test. Part 1 p. 227). A list maintenance transaction pursuant to IRC §6112 obligates the advisers to keep a list of particular individuals who have done transactions of a certain kind. (T.Test. Part 1 p. 146; Part 2 p. 229). A list maintenance transaction is not per se impermissible and the IRS's position on each transaction depends on the taxpayer's articulated non-tax business purpose. (T.Test. Part 1 p. 231).

114. Yale expressed his opinion that the Lev301 was subject to list maintenance as it was a potentially abusive tax shelter under IRC §6112. (T. Test. Part 2 p. 183). This listing was required because it was a high-fee transaction which resulted in a substantial benefit to the

taxpayer. Yale testified that this was not a confidential transaction so that was not a ground upon which he made his determination that this transaction was subject to list maintenance. (T. Test. Part 2 p. 193). Yale testified that while the opinion doesn‘t utter the words ―list maintenance,” in several places it places the taxpayer on notice that their name is going to be added to a list. (T. Test. Part 2 p. 46). He explained that there is no requirement for ―magic” or specific words to notify someone that list maintenance is required. (T. Test. Part1 p. 146).

115. In Yale‘s opinion, Grant Thornton advised Yung of the risk in Appendix I to the August 2001 Opinions which indicated that Grant Thornton was going to maintain a list of people to whom this transaction was suggested. (T. Test. Part 1 p. 136). He testified that most knowledgeable people would understand that this means you have a heightened risk of audit. (T. Test. Part 1 p. 136). He agreed that there are no appendices or references to ―listing” in the September 5, 2000, engagement letter or the December 28, 2001, short form opinion.

116. Yale testified that Grant Thornton also advised Yung of the risk in Appendix II to the opinion when it stated that knowledgeable people might disagree with Grant Thornton including the IRS. (T. Test. Part 1 p. 136). Yale believes that Appendix II to the opinion gave a very good warning about list maintenance even though those words or the words of the statute ―potentially abusive tax shelter” were not used. (T. Test. Part 2 p. 187). He believes the common man would have a better understanding with the Grant Thornton explanation. (T. Test. Part 2 p. 187).

C. Settlement

117. The Yungs appealed an IRS Notice that it planned to assess taxes due against the taxpayer for failure to pay dividend tax. In Yale‘s opinion the IRS basically acknowledged and agreed that the financial mechanics of this transaction occurred. (T. Test. Part 1 p. 126). He reviewed the settlement to determine the IRS‘s impression of the strength of their claim. He did

so to determine whether the Yungs were saying one thing before the IRS and a different thing to this court. (T. Test. Part 1 p. 127). He stated that under Circular 230 there is a duty of candor and as the Yung's representatives from Mayer, Brown, Rowe & Maw were saying the same thing then the statements as to business purpose must have come from the Yungs, not Grant Thornton, and thus must have been correct. (T. Test. Part 1 p. 198). The court finds this circular reasoning as false. Yale testified that Grant Thornton can enhance a business purpose without telling the Yungs, then claim the Yungs gave them the business purpose which they relied on and blame its failure on the Yungs. Further, this reasoning does not acknowledge that Grant Thornton never discussed tax motivation with Yung or that Grant Thornton's stated purpose for the Lev301 was tax avoidance.

118. Yale identified in the settlement a large carry-back resulting in a large refund to the taxpayer and additional income that was unrelated. In his opinion these issues were resolved only in their net effect. (T. Test. Part 1 p. 203). Yale testified he couldn't put his finger on all the settled issues to be precise about the actual impact of this transaction. (T. Test. Part 1 p. 204).

119. In Yale's opinion the claim by the Yungs that they suffered damages in the form of additional taxes, interest and/or penalties relating to the subject transaction is suspect. (T. Test. Part 1 p. 109; Report page 30). Yale testified the IRS conceded 35% of the deficiency but then imposed a 20% penalty on the 65% balance and the Yungs would pay interest. (T. Test Part 1 p. 199). The IRS has a policy that does not allow the settlement of cases for nuisance value. (T. Test. Part 1 p. 207). However, the IRS can settle for ―substantial uncertainty in the event of litigation as to how the courts would interpret and apply the law." (T. Test p. 210).

120. In his opinion this 35% reduction means that the IRS and the taxpayer had a mutual concession settlement. In other words the IRS has reviewed the hazards of litigation and

determined there is substantial uncertainty in the litigation so they should settle. (T. Test Part 1 p. 211). He believed the context of this settlement should be used to assess the damages to the Yungs in a more realistic calculation. He believed there should be a comparison between: (a) the Yungs‘ outcome in their settlement with the IRS; and (b) the result that they would have obtained if the Yungs were to have reported the transaction in accordance with the IRS's position on audit. In his opinion from this perspective, Grant Thornton's advice actually saved the Yungs a significant sum because, on audit, the IRS conceded one-third of the asserted deficiency, which offset the penalties in full and materially reduced Plaintiffs' tax bill." (T. Test. Part 1 p. 110).

121. On cross-examination Yale stated that he wasn‘t sure if he had reviewed the IRS examination report of the 1994 William Yung Family Trust. (T. Test. Part 2 p. 7; PX 1431-Bates Stamp Yung000313). He testified he could not say if the ―Summary of the Accuracy Related Penalty, IRC-6662" created on May 8, 2006, was before settlement negotiations began. (T. Test. Part 2 p. 8). However, he agreed that the there was a settlement conference on February 20, 2007. (T. Test. Part 2 p. 11). Yale also agreed that the tax deficiencies assessed against the Trust are the same on both documents. (T. Test. Part 2 p. 14). He agreed that there was no 35% concession in settlement to the Trust. (T. Test. Part 2 p. 15). He explained that there was ―horse trading" because they were all Yung-related entities and the benefit might have rebounded to the Yungs not the Trust. (T. Test. Part 2 p. 15). Yale agreed that there was no reduction in the amount of tax deficiencies to the Trust. (T. Test. Part 2 p. 18). He testified that as the IRS was entering into an overall settlement with Columbia Sussex Corporation, William and Martha Yung and the ‘94 Trust, and as there were other tax issues that it was entirely plausible that the taxpayer was granted a concession on the leveraged distribution. (T. Test. Part 2 p. 25). Yale disagreed that a penalty was assessed on the entire tax deficiencies at 13%. It is his thesis that

the IRS conceded 35% of the tax deficiencies and taxed the remaining 65% at a 20% penalty. (T. Test. Part 2 pp. 26, 27).

122. A mutual concession type of settlement uses Form 870-AD which was used in the Yung IRS settlement. (T. Test Part 1 p. 211). Yale agreed that this tax form is used as an offer form to the IRS for settlement, so it's not really a mutual concession as the IRS can decline the offer. (T. Test. Parts 1-2).

123. Yale testified that the civil penalties assessed by the IRS are based on IRC §6662 as to the '94 Trust for substantial understatement of income and for disregard of the rules and regulation and as to the Yungs' Form 1040 for disregard of the rules and regulations. (T. Test. Part 1 p. 212).

124. This assessment did not change his opinion regarding the soundness of Grant Thornton's advice because the transaction works and was meritorious. The fact that the IRS didn't like the transaction is not surprising as that is the nature of aggressive tax transactions. (T. Test. Part 1 p. 213). Yale testified that the Yungs used IRC§6664(c) to prove reasonable cause in good faith defense which was rejected by the IRS. The Yungs had the right to appeal this penalty in ligation where the IRS has the burden of proof. (T. Test. Part 1 p. 214).

D. Circular 230

125. Circular 230 contains the professional standards that apply to all professionals who provide federal tax advice, including CPA's and lawyers. Circular 230 outlines various levels of confidence for a tax professional's advice and requires that their advice to a client must have at least a one in three chance of success. (T. Test. Part 1 p. 217).

126. In Yale's opinion Grant Thornton met the Circular 230 realistic possibility standard because the Opinion was at a ―more likely than not" confidence level. (T. Test. Part 1 p. 217).

127. In Yale's opinion Grant Thornton ethically relied on the business purpose statements of the Yungs. Circular 230 §10.34(a)(3) says that tax professionals can rely on information supplied by their clients without verification so long as the information is not known to be false and is not dubious on its face. This rule is nearly verbatim in the Statement of Standards for Tax Service Rule No. 3, Statement 2. (T. Test. Part1 p. 218). The Circular allows the tax professional to rely on the statements of the client as long as the statements and representations are reasonable and the tax professional doesn't know as a fact that the client is lying. The professional does not have to look behind the statements unless there is some good cause for suspicion. (T. Test. Part 1 p. 219).

a) Yung's representations/business purpose: Yale testified that the business purpose doctrine allows the company to put its best foot forward. Therefore, as long as the taxpayer is truthful there is nothing that indicates ―you have to shoot yourself in the foot." (T. Test. Part 2 p. 202). In Yale's opinion based on his analysis of the companies' history of borrowing and based on his analysis of their business model it was ethical of Grant Thornton to rely on the statements and not do further investigation into the Yungs' representations. (T. Test. Part 1 p. 220). Yale did not take into consideration the gaming nature of Yung's businesses.

b) Disclosure of the transaction on the tax return: Yale testified that tax professionals are only required to discuss the possibility of disclosure with the taxpayer. It is the taxpayers' obligation to decide for themselves if they want to disclose the transaction to the IRS. Yale explained that this requirement for the tax professional to even discuss disclosure is only warranted if the penalty rules are reasonably likely to apply, and Grant Thornton concluded that penalties were not reasonably likely to apply because they thought the transaction worked. (T. Test. Part 1 p. 220).

128. Circular 230 requires that you advise your client on the ability to avoid the imposition of penalties through disclosure. (T. Test. Part 1 p. 222). This type of disclosure increases the potential for audit at the same time it may decrease the potential for penalty. So taxpayers have to make a strategic choice. In Yale's opinion Grant Thornton was under no obligation to discuss disclosure with the Yungs based on its ―more likely than not" opinion that a penalty was not reasonably likely. (T. Test. p. 224).

129. Yale agreed that if Grant Thornton had argued in their opinion that the regulations were invalid as tax professionals they would have been required to advise Yung to file a Form 8275-R with the Internal Revenue Service. This form discloses to the IRS that the taxpayer is taking a position on their tax return which is contrary to a regulation. In Yale's opinion Grant Thornton taking the position that the regulation is valid in the Opinion is ―careful practice" because prudent federal tax practice suggests that you should try to minimize and not maximize your client's audit risk. (T. Test. Part 2 p. 90).

130. The court found Mr. Yale's testimony to be incomplete and vague regarding the application of his expert opinion to the facts of this case. He appears to hold Yung to a higher professional standard than he does Grant Thornton. However, his technical explanations were in conformity with Hamersley's and agreed with Hamersley on some underlying premises.

III. *FOR THE PLAINTIFFS: DONALD FRITZ, C.P.A.*

131. Donald C. Fritz was called by the Yungs to testify about the professional responsibilities of tax practitioners.

132. Fritz graduated from the University of Dayton in Business Administration with a Major in accounting. He is a Certified Public Accountant licensed to practice in Kentucky and Ohio for approximately thirty eight years. (T. Test. pp. 92, 93). He began with Hurdman & Cranston,

which merged several times until it became Peat Marwick, now KPMG; he became a partner with Arthur Young who merged with Ernst & Ernst to become Ernst & Young. (T. Test. pp. 96-97). He left E&Y because of its concentration on publicly traded corporations, which was not his area, to join VonLehman & Company in 1992. (T. Test. p. 103). He became a shareholder in VonLehman in 1994. (T. Test. p. 104).

133. Fritz testified that the time he spent preparing tax returns including corporate, individual and pass-through entities has fluctuated from 20% to 25% of his practice yearly. (T. Test. pp. 94, 100). He reviewed approximately 350 tax returns last year. (T. Test. p. 104). He gives tax advice which fluctuates in time and from individuals to management as his practice grew and then changed from a national firm to a regional firm. (T. Test. pp. 94, 102). He does not write tax opinions. (T. Test. p. 211). He is a certified valuation analyst which, based on additional education and training, permits the valuation of businesses or other intangible assets. (T. Test. p. 109). Tax Professionals have continuing education requirements which include ethics training. (T. Test. pp. 108, 109).

134. In preparing tax returns a professional renders tax advice to clients regarding the nature and types of penalties that could be assessed by the IRS. (T. Test. p. 94). He worked his way up from staff person to partner. The responsibilities are the same but expanded so they include auditing, accounting, client service and taxes. (T. Test. p. 95).

135. He is responsible for supervising employees which includes supervising the exercise of professional judgment. (T. Test. p. 95). At Arthur Young, a national firm, he was a partner, and entrepreneurial services were added to his responsibility. He supervised 30 people, who serviced middle market non-publicly traded companies with three million to a hundred million accounts. (T. Test. p. 98). In this role he was required to review employees' performance; and as a

member of the quality control committee for Arthur Young he reviewed employees' level of confidentiality and independence in conformity with the Code of Professional responsibility. (T. Test. p. 102). He is currently a member of the quality control committee at Von Lehman. (T. Test. p. 105). He reviews a wide range of quality control issues which include the review of pronouncements and then implementing training on those issues, manages differences of opinion between service teams, and evaluates independence or personnel issue that infringe on service delivery. (T. Test. p. 106). The quality control committee doesn't review tax opinions for standards as the firm doesn't issue those as part of its practice area. (T. Test. p. 211). He has provided legal reviews in the Greater Cincinnati area. (T. Test. p. 123).

136. In his partnership role he was required to generate business by making proposals to companies in this responsibility range. (T. Test. p. 99). Fritz testified that presenting proposals to clients is governed by The Code of Professional Ethic solicitation standards. (T. Test. p. 99).

137. Fritz testified that Circular 230 and the American Institute of Certified Public Accountants (AICPA) and the standards of the State's Board of Accountancy govern the tax professionals in the **preparation of** tax returns. (T. Test. pp. 16, 216). Tax professionals who prepare taxes are referred to as ―paid preparers" and they are required to understand the types of penalties that could be assessed against a taxpayer by the Internal Revenue Service for understatement of income. (T. Test. p. 107). Kentucky's State Board of Accountancy has adopted these standards. (T. Test. p. 111). Fritz has testified as an expert twelve times but never on the standards of practice. (T. Test. p. 213).

138. Fritz testified that Circular 230 issued from the IRS governs the professional standards for offering federal income tax advice, tax preparation and tax opinions to clients. (T. Test. p.

112). His opinions are regarding tax advice and preparation, not tax opinions, although there is some overlap. (T. Test. p. 113).

139. He testified that his opinions in this case about professional responsibilities are based on presented fact scenarios and presented actions by the tax professional. He then determined if the professional actions taken regarding the tax portion of those facts met tax professionals‘ standards of care under either the AICPA or Circular 230. (T. Test. p. 114). Fritz testified that he was given facts to assume and did not do an independent investigation to validate those facts. (T. Test. p. 117). Grant Thornton waived a *Daubert* hearing but challenged Fritz‘s qualifications during cross examination. These challenges were based on a change in the fact patterns and Fritz‘s use of the general professional guidelines versus specific rules of conduct for each section. The court qualified Fritz as an expert on all matters he was called to testify upon. (T. Test. p. 118).

140. The court has organized and summarized the opinions of Fritz as to the various scenarios analyzed by him based on the order of presentation at trial and not in conformity with the Fritz Report.

141. SCENARIO ONE: "According to the testimony of Joseph Yung, John Michel informed Joseph Yung, in a very thinly veiled manner, that Grant Thornton had sold the leveraged distribution tax product to G.E. Aircraft Engines and Procter & Gamble prior to their discussion with the Yungs. The interrogatory responses of Grant Thornton plainly show that they, Thornton, did not sell the leveraged distribution tax product to either G.E. Aircraft Engines or Procter & Gamble." (T. Test. p. 7; Fritz Report page 7).

In Fritz‘s opinion this was a violation of the professional standards of care as: (1) it was misleading and/or a misrepresentation, and (2) a professional is required to be objective and independent. The profession requires integrity, honesty and candor. (T. Test. p. 124). Additionally, Circular 230 §54 and §1030 prohibit a tax professional from acquiring or having services provided to a client by providing false or misleading information. (T. Test. p. 125).

142. SCENARIO TWO: John Michel and Dean Jorgensen advised the Yungs to enter into the leveraged distribution strategy, and at the time they did so, J. Michel and Jorgensen believed that the IRS would characterize the leveraged distribution strategy as a listed transaction. A listed transaction is something that the IRS deems to be an abusive tax shelter.

In Fritz's opinion it was a violation of the professional standards of care for J. Michel and Jorgensen to fail to advise the Yungs of the IRS potential view of the leveraged distribution tax strategy as a listed transaction. It was a failure to provide the Yungs all of the pertinent facts. This is a due care issue that requires that clients have the information they need to make the best, most intelligent decision. (T. Test. p. 126). Being silent or not having an in-depth discussion in an area of potentially heightened disclosure and heightened regulation does not give the client the information they need, and its absence from a discussion is misleading as to the nature of the product and the risks. (T. Test. p. 126).

143. SCENARIO THREE: J. Michel and Jorgensen advised the Yungs to enter into the leveraged distribution strategy, and at the time that the engagement letter was being negotiated, J. Michel and Jorgensen understood that the leveraged distribution strategy was subject to a list maintenance requirement. (T. Test. p. 126).

In Fritz's opinion the failure to disclose list maintenance, if it was a material fact in the decision of the client to participate in the product, would be a deviation of the standard of care. (T. Test. p. 128). Due care and competence in the profession requires that a client be informed. The professional integrity standard makes it a tax professional's responsibility to give the client pertinent information. In Fritz's opinion if the tax professional is aware that the client is in the gaming industry informing a client of reputational issues is critical. (T. Test. p. 129).

144. SCENARIO FOUR: An August 14, 2000, e-mail exchange from Carlson to Jorgensen as employees of Grant Thornton states: ―Dean, I've read notice 99-59 and am worried. It appears that the IRS greatly disagrees with the proposition that a leveraged distribution can create a high basis, although they do not discuss the statutory provision that gets us there. The partnership piece is simply a mechanism to effect a disposition to create the loss. I have concern re the penalty implications mentioned in the notice, as well as the fact that they took direct aim at leveraged distributions. Your thoughts, please. Chris." (T. Test. p. 133).

[Yung claims this e-mail was not given in discovery until several weeks before trial and after the report of Fritz was rendered.]

Fritz testified that, as this transaction had heightened awareness issues that the IRS has ruled on, and as the organization internally is concerned, for a tax professional not to discuss this with the client during decision making, and/or to be silent, prevents the client from making an honest, unbiased decision. (T. Test. p. 133). In Fritz's opinion the failure to inform the Yungs of this information would be a violation of the professional duty of care. (T. Test. p. 134).

145. SCENARIO FIVE: Grant Thornton believed that the IRS would view the leveraged distribution strategy as a listed transaction; and that Grant Thornton knew, or should have known, that state gaming regulators might view Mr. Yung's participation in a transaction the IRS characterized as a listed transaction adversely to his reputation. Grant Thornton had previously assisted in the licensing process of gaming companies, and was familiar with the regulatory environment in which hotel casino properties operated in Nevada. (T. Test. p. 137). Grant Thornton professionals had worked with the Nevada Gaming Control Board on specific client matters, as well as general industry matters, that broadened their perspective of the industry.

[This scenario is based on PX 826 page 9, an entered document, which was received 1.5 months before trial and Grant Thornton says they were not notified.]

In Fritz's opinion Grant Thornton's failure to advise Yung that state gaming regulators would take a negative view of participation in a listed transaction would be a breach of duty and violation of professional competency because it is a relevant piece of information and critical to the decision process of someone in the gaming business. (T. Test. p. 140). A tax professional cannot remain silent, especially when they know the gaming concerns regarding tax avoidance. A tax professional is required to minimize the client's exposure to risks and failure to put relevant information before a client is a violation of professional standards. (T. Test. p. 141).

146. SCENARIO SIX: At the time Grant Thornton entered into the leveraged distribution engagement with the Yungs it was of the belief that the leveraged distribution transaction could be unwound for tax purposes. The fact that the transaction could be unwound was not disclosed to the Yungs prior to their entering into the leveraged distribution transaction on December 29, 2000.

Fritz testified that the failure of Grant Thornton to advise the Yungs of the ability to unwind the transaction is a deviation from and a violation of the competence and the professional standards because it is a critical factor the client should know when making the decision to enter a transaction. Fritz testified when a transaction has associated heightened potential for disclosure or reporting requirements because of its tax avoidance properties and thus heightened penalties the client deserves to know all of the possibilities and risks. Grant Thornton violated the professional standard as they did not fully disclose and give relevant information to their client which once again is misleading to the client. See Circular 230 §54. (T. Test. p. 143). Additionally, in Fritz‘s opinion this failure to be candid created a conflict between the tax professional and the client. The required professional objectivity was gone because the tax professional was making decisions for the client by not disclosing. (T. Test. p. 144).

147. SCENARIO SEVEN: On December 28, 2000, J. Michel sent a letter to the Yungs that contained an opinion as to the tax consequences of the leveraged distribution transaction. Michel intended for the Yungs to rely upon the opinion contained within that December 28, 2000 letter. Additionally, on that date Grant Thornton had not actually reached a ―more likely than not" confidence level on the product internally.

Fritz testified that to issue an opinion that hadn‘t reached the stated conclusion was not rightfully justified by the firm. It violated the integrity requirements of the codes and professional competency. It also violated the professional competence requirement of due care in tax professional conclusions. (T. Test. p. 146).

In Fritz‘s opinion even if the December 28, 2000, letter did not contain the sentence, ―You may rely on this representation to complete the transaction as proposed and discussed most recently on 12-28-00." Grant Thornton was still presenting an opinion that is not supported. (T. Test. p. 147). It is also Fritz‘s opinion that to express an opinion to a client that is not supported does not meet the public‘s expectation of the profession and violates the public trust. It is his opinion that clients rightfully expect that what is put in front them, especially in writing, is based on the accountant‗s best judgment, supported by due care, and is truthful in every way, and they can rely on it. (T. Test. p. 149).

148. SCENARIO EIGHT: J. Michel on January 10, 2001, sent an e-mail to Marquet as a representative of Yung – the e-mail marked as PX 64. That e-mail assured the Yungs about the regulations. Additionally, J. Michel represented that the revised master opinion would indicate that the regulation had a more favorable impact on the transaction. At the time of this e-mail Grant Thornton had not reached a conclusion regarding the impact of the January 4, 2001, treasury regulation. (T. Test. p. 150).

Fritz stated that if the e-mail contained anything misleading, if it contained something that was not supported, it violated the duty to be honest and candid. If it was not an objective statement it was personal and violated the professional standards for integrity.

149. SCENARIO NINE: On January 23, 2001, J. Michel sent an e-mail which stated: ―We made a decision that the effective date of the new reg‗s was not an issue, and I used that to buy more time with the client."

[The Yungs claim this document was received late in discovery.]

In Fritz‗s opinion ―buying more time" is not properly informing your client and is a violation of the professionals‗ duty of integrity and candor to the client. (T.Test. p. 153).

Fritz testified that, generally speaking, a professional is required to keep his or her clients informed of changing circumstances with respect to a transaction. It is the duty of a tax professional to keep their clients as well advised and educated as possible. (T. Test. p. 154). It is fair to keep a client aware so they can change their minds. It is not fair to ask them to make a decision without all the facts. (T. Test. p. 154). He stated that this failure to properly inform the client and use it for a non-professional reason is a violation of the code of professional standards. (T. Test. p. 154).

150. SCENARIO TEN: On January 8, 2001, Grant Thornton made a decision to temporarily stop selling the leveraged distribution product to clients, and stopped advising clients to enter into the leveraged distribution strategies based on the January 4, 2001, regulation release. These facts were not disclosed to the Yungs at that time. (T. Test. p. 154).

In Fritz's opinion the fact that circumstances were changing and that they lacked confidence as to viability of the product is relevant and the client should be given all the facts necessary to make a good decision for themselves. This action lacked integrity, honesty and candor and violated the standards of professional competence. (T. Test. p. 156). Fritz testified as this is a significant, $30 million, transaction with a significant amount of tax and potential penalty, a tax professional is required to advise a client of all the ways to avoid or mitigate a negative situation. Additionally, the tax professional's silence on the issue of potential unwinding of the transaction is a violation of professional standards. (T. Test. p. 156).

151. SCENARIO ELEVEN: Grant Thornton was of the belief that the transaction could be unwound before and after the issuance of the January 4, 2001, regulations. Grant Thornton failed to advise the Yungs that it was their opinion that the transaction could be unwound with little or no adverse federal income tax consequences.

Fritz testified that in this evolving situation there was a change of circumstance in this heightened tax matter and the client was entitled to be fully informed. A tax professional is required to disclose so that the client can make a fully informed decision. Not to inform the client is misleading and creates the impression that there are no options. This is a violation of the tax professionals' obligation of integrity, honesty and candor. Circular 230 §54, §201. (T. Test. p. 158).

152. SCENARIO TWELVE: On August 13, 2001, Grant Thornton delivered two tax opinion letters to the Yungs. The primary author of both tax opinion letters was Richard Voll. The second reviewer of those tax opinions was J. Michel. J. Michel stood to receive a commission on the payment of a $900,000 fee that was payable in connection with the two opinions.

Fritz said that the qualifications to be a second reviewer is a question of quality control. The second review should be someone who does not have a direct interest in the engagement and as a result will view the product with an objective and independent view. (T. Test. p. 161). To the extent that J. Michel had an interest in the transaction he had a conflict. It is difficult to perceive the professionally required impartiality, intellectual candor and honesty that is required from a tax professional. In his opinion pressures, either perceived or actual, violated the spirit of the code and thus professional standards were not met. (T. Test. p. 161).

153. SCENARIO THIRTEEN: In the August 13, 2001, Yung Opinion letters, Grant Thornton made an argument that there was economic substance for the leveraged distribution tax transaction. The basis for their conclusion as to the economic substance for the transaction was the potential arbitrage between the bank loan and the value of the purchase and encumbered treasury notes. In reaching that conclusion with respect to the finding of economic substance, Grant Thornton failed to account for the cost of the of $900,000 fee paid by the Yungs for the opinion letter. (T. Test. p. 165).

Fritz's opinion is that in general a CPA has a duty to consider all relevant factual data in rendering tax advice and any failure to do so is a deviation from the standard of care. It is a failure because not considering all relevant information is a violation of due care and the misapplication of information violate the standards of competency required of a CPA. Circular 230 §1033. (T. Test. p. 167).

154. SCENARIO FOURTEEN: The tax returns filed by the Yungs for the year 2000 were reviewed by Sarah Williams, who was a Grant Thornton employee. It was Grant Thornton's opinion that the transaction occurred, for tax purposes, in the year 2000. Sarah Williams signed the returns for the Yungs for that year. Williams failed to conduct an independent investigation of whether, in fact, the transaction needed to be disclosed. (T. Test. p. 168).

Fritz testified that if Williams did not conduct an independent investigation in her role as paid preparer she was not independent, objective, impartial, or free of conflict. There is a heightened awareness for paid preparers because a penalty is attached. It is perjury for a paid preparer not to give true, correct and complete information. As a tax professional with both professional and personal responsibility only you can decide if something should or shouldn't be on a return. (T. Test. p. 169). Fritz testified he read Williams' deposition and she indicated that the decision to enter zero was above her pay grade so she just entered zero for the transaction. Her responsibility was to the taxpayer for the preparation of the tax return for the IRS regardless of the firm's position. (T. Test. p. 170). In Fritz's opinion Williams had a professional responsibility to talk with the Yungs independently about the potential for penalties regarding this entry on their tax return. Circular 230. (T. Test. p. 171). If all she did, as she stated, was to ask J. Michel for direction on this issue she also violated Circular 230 because that alone would not satisfy her duty to investigate in an objective fashion. (T. Test. p. 173).

155. SCENARIO FIFTEEN: In 2002 the Treasury Department promulgated regulations that created a definition of "substantially similar," and that creation created an obligation on the part of the Yungs to disclose the 2000 year leveraged distribution transaction. Grant Thornton failed to make the Yungs aware that they had the ability to disclose the 2000 year leveraged distribution transaction on a subsequent federal income tax return after the date of these new regulations. (T. Test. p. 180).

Fritz said that if this scenario is correct, the client is entitled to know of the IRC change, so disclosure of this reporting change by the tax professional to the client is necessary. Fritz testified that this was a significant transaction for Grant Thornton, as well as the Yungs, so its failure to inform the client of this change lacked the necessary professional objectivity. (T. Test. p. 181). Fritz testified that there is a responsibility to assist clients to avoid or mitigate penalties, so he doesn't understand why Grant Thornton wouldn't inform the Yungs about these developments in the regulations.

Fritz testified that there are simple processes to amend prior year tax returns to include such income. (T. Test. p. 181). The income from the dividend distribution could have been reported either on the tax return or by attaching a declaration that you've taken a position in the return. (T. Test. p. 174).

Grant Thornton had to know this was an IRS hot button and that the IRS was seeking people who participated in these types of transactions which had serious penalties. (T. Test. p.

181). Fritz testified if the taxable income reported on a return is less than what it should be, you pay less tax. If you understated income the IRS can assess a willful penalty for understatement. The IRS has different tiers of penalty amounts for the percentage of underpayment. (T. Test. p. 177).

In Fritz's opinion Grant Thornton's obligation to inform its client continued even after Tax Opinion Letter and not just because they did subsequent year income tax returns but because they made a entry determination on the 2000 tax returns. (T.Test. p. 182). He noted that the decisions on how to report both the dividend distributions and the repayment of the loans were made by Grant Thornton so they had a continuing obligation to the taxpayer to advise them about changes in the tax law that affected their returns. (T. Test. pp. 183,184).

156. SCENARIO SIXTEEN: In 2002 Grant Thornton was put under examination for its compliance with list maintenance requirements and registration requirements. In December 2002 Grant Thornton received a summons asking it to produce the names of all of the individuals who had utilized the Grant Thornton leveraged distribution strategy. Compliance with that summons would result in Grant Thornton providing the name of the Yungs to the Internal Revenue Service as participants in the leveraged distribution strategy. That production of the names to the Internal Revenue Service would result in an increased risk of audit to the Yungs. The Yungs found out about this summons by reading a newspaper article. Grant Thornton did not disclose that fact to them until after the clients had, in fact, discovered the existence of the summons through reading the newspaper. (T. Test. pp. 184-185).

Fritz stated a prudent practitioner would know why the IRS was asking. This knowledge would be based on the product and the tax environment at that time and would include knowledge of the specific purpose given by IRS. The client has a right and deserves to know about this type inquiry, especially given the magnitude of the potential penalty. In Fritz's opinion in this scenario the tax professional lacked candor and integrity and violated the codes of professional competency and ethics. Circular 230 §1034; AICPA. (T. Test. pp. 187, 189). It is also Fritz's opinion that the tax professional might potentially have a conflict of interest. (T. Test. p. 190).

Fritz testified that the statute of limitations would still have been open for the Yungs to amend the prior year taxes. (T. Test. p. 187). He further stated that in his experience the voluntary amendment of a tax return, even if it triggers an audit, mitigates the penalties. (T. Test. p. 188). The failure of Grant Thornton to advise the Yungs of these circumstances deprived them of an opportunity to mitigate potential penalties.

157. SCENARIO SEVENTEEN: In 2003 Columbia Sussex was under audit by the Internal Revenue Service. Columbia Sussex is a Subchapter S corporation. William Yung is the shareholder in Columbia Sussex. On March 5, 2003, Columbia Sussex received an IDR request from the IRS. The request stated: ―The purpose of this IDR is to determine whether Columbia Sussex has directly or indirectly participated in transactions that are the same as or substantially similar to any listed transaction." The IDR explained the scope of their request as: "A taxpayer will have indirectly participated in a listed transaction if the taxpayer's federal income tax liability is affected or in the case of a partnership or an S corporation if a partner's or shareholder's federal income tax liability is reasonably expected to be affected." IDR 6, PX1395. (T. Test. pp. 191, 192).

Fritz noted that Yung was a participant in the transaction as a shareholder in an S corporation and as such he was under a duty to disclose the leveraged distribution transaction to the IRS in response to an inquiry as to whether he had engaged in any listed transactions. (T. Test. p. 192). Fritz testified that Circular 230 requires that you comply with a request, not omit any information, and that the information be accurate and prompt. (T. Test. p. 194).

158. SCENARIO EIGHTEEN: The Yungs received a notice of audit in early 2004, and the notice of audit was in connection with the Yungs' 2000 year tax return. That audit was by product of their participation in the leveraged distribution strategy that was recommended to them by Grant Thornton. Following their receipt of the notice of audit in early 2004, Grant Thornton continued to advise the Yungs that the leveraged distribution strategy was viable. On November 29, 2004, Grant Thornton permanently stopped advising clients to participate in the leveraged distribution strategy. (T. Test. p. 200).

In Fritz‘s opinion based on the professional responsibilities of candor and integrity to a client, Grant Thornton should have informed the Yungs on November 29, 2004, that they had discontinued the Lev301 product because it lacked marketability, they had lost confidence in it and viewed it as a ―potentially abusive tax shelter, because they determined the IRS was likely to view the product as a listed transaction." Circular 230 §§53-54. (T. Test. pp. 199, 200). This failure by Grant Thornton was a deviation from the standards of care. (T. Test. p. 200).

Fritz testified that Grant Thornton‘s removal of the product infers a lack of support in the product‘s competence. Circular 230 §34, which talks about the responsibility to avoid and mitigate penalties, and §1024, which concerns the prompt disposition of matters before the IRS, would require Grant Thornton in due care regarding integrity, honesty, and candor to evaluate the situation and advise the client. (T. Test. p. 202).

159. Fritz testified that his opinions were delivered to a reasonable degree of professional certainty regarding the Yungs, and were applicable, except for those opinions regarding a paid preparer, to the 1994 Yung Family Trust. (T. Test. p. 204). Fritz agreed on cross-examination that if a fact changed in each or any of the scenarios that his opinion regarding that scenario may also change.

CONCLUSIONS OF LAW

I. GRANT THORNTON'S LIMITED LIABILITY CLAUSE

1. The court must now determine the validity of Grant Thornton's legal argument that damages are limited to $900,000.00 based on the final engagement letter executed between the parties on September 15, 2000. (PX 23; PX 28).

2. The Final Engagement Letter states, ―The Firm's maximum liability to the Companies and its shareholders arising for any reason relating to the Opinion shall be limited to the amount of fees paid for this engagement."

3. It is clear from the court's findings that at the time the engagement letter was issued to Yung on September 15, 2000, Grant Thornton and its agents were aware that: (1) several of the Opinion's major tax issues had not attained a ―more likely than not" standard, (2) listing was required, and (3) client notification of the listing was required. Thus the Lev301 product was not yet viable. The Yungs were not notified of Grant Thornton's concerns with the viability of the product nor notified of the listing requirement. Grant Thornton could have disclosed this information or advised the Yungs not to proceed up to and including the day of the closing of the transaction, December 28, 2000.

4. While it is evident that the Yungs' are sophisticated parties that contracted an ―arms' length" transaction, this contract cannot be limited to the four corners of the document as so much vital information was withheld from the Yungs. With information being withheld there is an imbalance of bargaining power and no mutual meeting of the minds. Withholding the listing requirement was clearly fraudulent.

5. Kentucky holds as a matter of public policy that a person or business cannot contract against his fraud. *U.S. Achievement Academy, LLC. V. Pitney Bowes, Inc.*, 458 F. Supp. 2d 389, 399 (E.D. Ky. 2006), citing *Bryant v. Troutman*, 287 S.W.2d 918, 921 (Ky. 1965).

6. In *Peoples Bank of Northern Kentucky, Inc. v. Crowe Chizek & Co., LLC*, 277 S.W.3d 255, 263 (Ky. App. 2008) (citing *Hargis v. Baize*, 168 S.W.3d 36, 47 (Ky. 2005)) the court held that professional agreements to release or waive future liability for ordinary or gross negligence are “generally disfavored and are strictly construed against the parties relying on them.”

7. *Hargis,* citing 57A Am.Jur.2d, Negligence §53 (2004), set forth a four-prong analysis to determine if the language of an agreement supports a waiver and release of future liability for ordinary or gross negligence. The agreement is enforceable if:

> (1) it explicitly expresses an intention to exonerate by using the word “negligence;” or
> (2) it clearly and specifically indicates an intent to release a party from liability for a personal injury caused by that party‘s own conduct; or
> (3) protection against negligence is the only reasonable construction of the contract language; or
> (4) the hazard experienced was clearly within the contemplation of the provision,

otherwise is it is not enforceable.

8. It is clear from the court‘s findings that the word “negligence” is not used in the Yungs‘ engagement letter as it was in subsequent Grant Thornton engagement letters for Lev301. The “any reason” language of the Yung‘s letter does not clearly and specifically indicate an intent to release Grant Thornton from liability for injury caused by their “professional negligence”. The use of these words in the engagement letter contemplates the types of events that occur when a client is fully informed of the IRS regulatory environment, and the events aren‘t generated because of “professional negligence” but fact based risk taking; it could also contemplate third party liability. Thus negligence is not the only reasonable construction of the contract language or clear meaning that can be taken from the four corners of the document. This provision did not

contemplate the hazard of Grant Thornton‘s failure to provide a ―more likely than not" standard Opinion Letter for the Lev301 strategy because of confusion and miscommunication, mismanagement and fraud.

9. It is clear from the court‘s findings that at the time the December 28, 2000, Opinion was issued to the Yungs that Grant Thornton and its agents were aware or should have been aware that: (1) the Yungs‘ financial transactions documents were recourse documents; (2) listing was a probability and had never been verbalized to the Yungs; (3) the motivation for the financial transaction, while in conformity with the purpose of Lev301, was not sufficient to sustain a finding of a legitimate ―business purpose" and thus the opinion did not meet the ―more likely than not" standard; and (4) the research on the viability of the Lev301 product was not complete.

10. The court concludes that the ―any reason" language in the final engagement letter does not protect Grant Thornton from negligence or malpractice and holds that the language of this letter does not limit the monetary damages of the Yungs and the '94 Trust in this action.

II. GRANT THORNTON'S VICARIOUS LIABILITY FOR THE ACTIONS OF ITS AGENTS

11. Grant Thornton is a limited liability partnership. J. Michel, Jorgensen, Voll, Horak, Stutman, Gould, Keith, Agahi, and Williams were all partners of the firm during the 2000 to 2005 time frame of development, sale, and processing of the Lev301 strategy, preparation of the Yungs tax returns and the IRS audit of CSC and the Yungs. Grant Thornton as a partnership executed the Opinion Letter and received the $900,000.00 fee.

12. A partnership is liable for a partner‘s wrongful act that occurs in the ordinary course of business of the partnership and is bound by any fraudulent act or breach of trust committed by a partner to further the partnership‘s business. *Flightmaster v. Leffler*, 556 S.W.2d 180, 182 (Ky.App. 1977). *See also* KRS§362.210.

III. AGENCY OF PLAINTIFFS AND THEIR ASSOCIATES

13. Agency exists where ―there has been a manifestation by the principal to the agent that the agent may act on his account, and consent by the agent so to act." *Terbovitz v. Fiscal Court of Adair County*, 825 F.2d 111, 116 (6th Cir. 1987), overruled on other grounds; see also Restatement (Third) of Agency §3.01 (2006). ―[W]hen a fraud is worked upon an agent, the fraud is considered as worked upon his principal who is damaged thereby." *Liberty National Bank & Trust Co. v. Gruenberger*, 477 S.W.2d 503, 505 (Ky. 1972).

14. Yung was acting as the agent for Wytec and Casuarina and their shareholders and was authorized as such when he entered into the Engagement Letter with Grant Thornton for the Lev301 strategy. Yung was acting as the agent for the '94 Trust and Martha Yung (as successor to the GRAT's) as they were shareholders of Casuarina during the entire transaction**.**

15. Joe Yung, T. Mitchel and Marquet were agents of Yung when they interacted with Grant Thornton for all purposes of the Lev301 strategy.

16. Joe Yung as investment advisor for the '94 Trust was its agent when interacting with Grant Thornton.

IV. FRAUD

A. MISREPRESENTATION

17. A party alleging fraud by misrepresentation must establish six elements by clear and convincing evidence:

(1) a material misrepresentation:
(2) which is false;
(3) known to be false or made recklessly;
(4) made with inducement to be acted upon;
(5) acted with reliance thereon; and
(6) causing injury.

United Parcel Service Co. v. Rickert ("UPS"), 996 S.W.2d 464, 468 (Ky. 1999).

18. A misrepresentation must be of a past or present material fact, which includes a statement of opinion or a prediction if it falls within one of Kentucky‘s ―deception exceptions.” *Republic Bank & Trust Co. v. Bear Stearns & Co., Inc.*, 683 F.3d 239, 249 (6th Cir. 2012), citing *Flegles, Inc. v. TruServe Corp.*, 289 S.W.3d 544 (Ky. 2009).

19. ―Fraud claims based on opinions or predictions may lie where the opinion or prediction *either* (1) incorporates falsified past or present facts *or* (2) is so contrary to the true current state of affairs that … [it] is an obvious sham.” *Id.,* (citing *Flegles* at 549). The ―[d]ishonest expression of opinions contrary to those really entertained by the speaker,” when made deliberately, can support a claim for fraud. *Edward Brockhaus & Co. v. Gilson*, 263 Ky. 509, 92 S.W.2d 830, 835 (1936).

20. A matter is material if ―a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question” or ―the maker of the representation knows or has reason to know that its recipient is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it.” *Restatement (Second) of Torts* §538.

21. The recipient of a fraudulent misrepresentation of opinion is justified in relying upon that opinion when the person making the fraudulent misrepresentation of opinion:

> (a) purports to have special knowledge of the matters that the recipient does not have, or
> (b) stands in a fiduciary or other similar relation of trust and confidence to the recipient, or
> (c) has successfully endeavored to secure the confidence of the recipient, or
> (d) has some other special reason to expect that the recipient will rely on his opinion.

Flegles at 551 (quoting *Restatement (Second) of Torts* §542). A plaintiff can show reliance by demonstrating that he acted or failed to act due to the fraudulent misrepresentation. *UPS* at 469.

22. ―A person is entitled to damages resulting from inaction when an untrue statement is made with the intent to induce that person to refrain from acting so long as it can be demonstrated that the false statement produced the inaction." *UPS* at 469. Under the collateral source rule, a tortfeasor cannot receive credit for benefits conferred on a victim by a source other than the tortfeasor. ―The law does not differentiate between the nature of the benefits, so long as they did not come from the defendant or a person acting for him." *See, Baptist Healthcare System, Inc. v. Miller*, 177 S.W.3d 676, 683 fn.16 (Ky. 2005) (quoting *Restatement (Second) of Torts* §920A (1979)).

1. FALSE REPRESENTATIONS:

23. The court concludes that J. Michel, Jorgensen and Voll made numerous material misrepresentations to Yung regarding the nature and risks of the Lev301 product from July 2000 until the termination of their relationship.

a. The "worst case scenario" representation

24. This misrepresentation was that if Yung engaged in the Lev301 strategy an IRS audit would not result in penalties but only require the shareholders of Wytec and Casuarina to pay the taxes on the distribution with interest. This representation appears in the July 24th notes of both T. Mitchel and J. Michel. At the time this representation was first made the research on the strategy had not reached a ―more likely than not" standard. Additionally, the tax product environment was such that Grant Thornton knew this product had a ―short shelf life" and that the IRS and Congress were becoming aggressive in seeking penalties for tax shelter products they viewed as abusive. While this court agrees that the IRS's ―hating" a strategy doesn't necessarily mean the product will be litigated to defeat, it does mean that a professional would be required to caution clients about the potential IRS penalty damages especially if their product had not yet

been fully vetted to the ―more likely than not" standard. The failure to notify of the short shelf life and the higher risk of audit, and the sham that no penalties would be assessed, were material inducements to Yung to participate in the Lev301 strategy.

b. The G.E. and P&G representation

25. J. Michel, who was a continual presence at the CSC building, represented to Joe Yung, who did not want to be the ―guinea pig" with respect to the Lev301 strategy, that a local large aircraft engine manufacturer and a local large consumer products manufacturer had utilized the strategy. This statement was patently untrue. J. Michel had no knowledge that G.E. or P&G had utilized the strategy and there was no evidence presented that those companies were ever contacted about this product by J. Michel or any other Grant Thornton representative. J. Michel knew this ―comforting" information would be material to Joe Yung in his discussion with Yung and was presented to allay his fears about being the first to use the strategy. J. Michel knew it was material to the inducement to Yung to participate in the Lev301 strategy.

c. The "more likely than not" confidence level for Lev301

26. Voll‘s testimony establishes that Grant Thornton had not reached a more likely than not confidence level in the Lev301 until August of 2001.

27. This is the ―point of no return" misrepresentation. On December 28, 2000, Grant Thornton had its final opportunity to correct its prior errors regarding ―listing," ―recourse," and its inability to issue a ―more likely than not" standard Opinion. No financial transaction had occurred and no tax returns had been filed. Grant Thornton could have said something to the effect that, ―We do not have a ‗more likely than not‘ opinion and you should not go through with the transaction until we do, or not go through with it at all."

28. Grant Thornton misrepresented in writing on December 28, 2000, that it was ―of the opinion" that it was ―more likely than not" that a court of law would uphold the non-taxability of the Lev301 transaction. Grant Thornton's confidence level in its opinion was extraordinarily material to the Yung decision to authorize the Lev301 distributions, and to the decision to not report the income on the Yungs' and the '94 Trust's 2000 and 2001 federal income tax returns.

29. In the Draft Wytec Opinion Letter of February, Grant Thornton had not yet determined what the impact of the January 4th Regulations would be on its opinion, and was no longer selling the Lev301 to clients, thus had not yet released nor believed that they had a ―more likely than not" standard.

30. Lastly, in the August 13, 2001, Final Opinion Letters, Grant Thornton also represented that it held a ―more likely than not" confidence level with respect to the Wytec and Casuarina Lev301 distributions. However, Grant Thornton based these opinions on the belief that the Firstar Bank loan documents for the Lev301 transaction were nonrecourse. Additionally, J. Michel and Voll knew that Yung did not satisfy the ―business purpose" doctrine as the transaction was motivated by a tax purpose in making the distributions.

d. The "it's all good" misrepresentation of January 2001

31. On January 10, 2001, J. Michel represented to Marquet in an e-mail that Grant Thornton was of the opinion that the January 4th Regulations did not adversely affect the Wytec and Casuarina transactions because of the effective date of the regulations. He further represented that Grant Thornton was of the opinion that the regulations would actually bolster the strength of Grant Thornton's opinion. As of January 10, 2001, Grant Thornton had not reached a conclusion regarding the effect of the January 4th Regulations on the Lev301. The applicability or inapplicability of the January 4th Regulations to the December Lev301 transactions was, of

course, material to the degree of risk associated with not reporting the income from the distributions on the Yungs' and the '94 Trust's federal income tax returns. The Yungs, in reliance on this representation, did not seek a rescission of the initial step of the Lev301 transaction, paid the interest bill on the loan, and continued with the advice of Grant Thornton.

2. INDUCEMENT

32. The court concludes that the misrepresentations by Grant Thornton were made to induce Yung and the '94 Trust to pay the $900,000.00 fee for the opinion letter. There was an initial payment to Grant Thornton at the issuance of the opinion letter of December 28, 2000 (that being the letter upon which Yung and the '94 Trust relied to execute the first and second steps of the Lev301 transaction). The bulk of the fee was not due until Grant Thornton had completed the contract and delivered the final opinion letter, which was relied upon by Yung and the '94 Trust to complete the third step of the Lev301 transaction.

3. REASONABLE RELIANCE

a. The "worst case scenario" representation

33. J. Michel, as an agent of Grant Thornton, had established a very close working relationship with T. Mitchel. T. Mitchel, Joe Yung and Marquet placed enormous trust in J. Michel to render suitable tax advice. It was Sara Williams' debriefing by J. Michel that lead him to approach the Yungs and the '94 Trust with Lev301. T. Mitchel and Marquet also placed enormous trust in Sara Williams, whom they hired away from Grant Thornton and whom, as a Grant Thornton agent, they listened to at the time the Lev301 strategy was being marketed to Yung and the '94 Trust.

34. There was no duty by Yung or the '94 Trust, directly or through its agent T. Mitchel, to achieve the same level of expertise as their tax advisors J. Michel and Grant Thornton's

specialist Jorgensen. If this was required there would be no need for tax advisors or specialists such as Grant Thornton.

35. Grant Thornton orally reiterated the fact that only taxes and interest would be due in the –worst case” at the initial introduction and again in the July 24th meeting. Grant Thornton then made this representation in writing in the Final Engagement Letter, stating that the opinion –should preclude the successful imposition of penalties by the IRS”, and again in the December 28, 2000, Opinion Letter stating that Yung and the ‘94 Trust –will not be subject to any tax penalties in relying in good faith upon,” Grant Thornton‘s opinion.

36. Grant Thornton is a public accounting firm who, with knowledge that Yung was reviewing tax savings strategies through trusted advisors, presented through those same trusted advisors their tax savings strategy and assurance of their expertise in this area. The court concludes that, as the relationship with Grant Thornton was one of established trust and the representations were consistent, Yung and the ‘94 Trust reasonably relied on the representations that only interest and taxes would be assessed in the –worst case” scenario.

b. The G.E. and P&G representation

37. Joe Yung sought reassurance about the Lev301 product from J. Michel. J. Michel was the trusted and long-time advisor and Jorgensen was just a specialist from Washington. J. Michel‘s assurance was relied upon by Joe Yung in his position as Investment Advisor for the Trust. Additionally, J. Michel knew of Joe Yung‘s desire to minimize his travel for investment opportunities so as to spend more time at home with his family. He also knew that Joe Yung was one of Yung‘s closest advisors and the obvious –heir apparent”. This representation was made to encourage Joe Yung to push for the use of the Lev301 strategy by Yung and the ‘94 Trust. A client of Grant Thornton would be entitled to confidentiality and, remembering that J. Michel

referenced this confidentiality by alluding to G.E. and P&G by business use rather than by name, there would be no way for Joe Yung or others to verify the use of the product by these entities. The court concludes that Yung and the '94 Trust reasonably relied on this representation made to their agent Joe Yung.

c. The "more likely than not" confidence level for Lev301

38. The December 28, 2000, letter, issued before the first step of the Lev301 strategy was executed, stated, “You may rely on this representation to complete the transaction as proposed and discussed most recently on 12/28/00." This letter is signed by J. Michel as agent of Grant Thornton. While the testimony indicates that Marquet and T. Mitchel, as agents for Yung, were expecting a final or formal opinion letter, there is nothing contained in this letter to indicate that Grant Thornton's opinions had not reached the standard of “more likely than not." The court concludes that Yung and the '94 Trust reasonably relied on the representations made in this letter from Grant Thornton.

39. The August 2001 Wytec and Casuarina “Opinion Letters" are each 74 pages, with attachments. They state that the Lev301 strategy is guaranteed at a standard of “more likely than not." The substance of these letters, as well as the approach to “business purpose," had changed significantly since the July 2000 meetings and the December 28, 2000, opinion letter. However, none of these substantial changes were brought to the attention of the client.

40. Furthermore, Grant Thornton argues that Voll's use of the word “nonrecourse" in the body of the final August opinion put the client on notice of the requirement that the loans had to be nonrecourse. The court finds nothing in the opinion that clearly notifies the client of this requirement. The testimony is clear that Grant Thornton's agents never shared the same definitions of “recourse" or “nonrecourse" throughout the process with Yung, so it is

disingenuous of Grant Thornton to argue that Yung should have had a clear understanding and knowledge of this concept. Additionally, there is nothing in the record to indicate that Yung, the '94 Trust, or any of its agents, were aware that they were required to have Grant Thornton's professional advice analyzed. To the contrary, the evidence establishes that such seeking of a second opinion was thwarted and discouraged by Grant Thornton from day one because of its fear that another accounting firm might steal their product.

41. The court concludes that Yung and '94 Trust reasonably relied, and were entitled to rely, upon its trusted tax advisor and Grant Thornton professionals when accepting their representations that this tax product was guaranteed at a ―more likely than not standard" and that no taxable income would result from this transaction. Secondarily the court concludes that the Yungs reasonably relied on the representations of J. Michel as agent for Grant Thornton when they filed tax returns in 2000 and 2001 and did not report the $30,000,000.00 distribution.

d. The "it's all good" misrepresentation of January 2001

42. On January 4th only two steps of the transaction had been completed and thus the Lev301 strategy was not complete. It is clear from the testimony that Marquet and T. Mitchel, as agents for Yung, were concerned with the effect of the January 4th Regulations on the strategy. Marquet inquired of J. Michel about abandoning the deal because of these regulations. It should be noted that Marquet did not address the ―more likely than not" letter of December 28, 2000, but the product going forward. The court concludes that Yung and the '94 Trust reasonably relied on J. Michel's representations that ―it's all good" and in fact ―may even be better for the strategy" when they took no action in response to the regulations.

43. Secondarily to this misrepresentation was the failure of J. Michel and the other professionals at Grant Thornton to advise Yung and the '94 Trust of the possibility, and perhaps

necessity, of unwinding the Lev301 transaction in a fashion that would have no adverse tax effects on the distribution under the first two steps of this transaction. The e-mails and the dialogue regarding how a client of this importance should react to these January 4th regulations were careless and a material misrepresentation.

4. *DAMAGES: RELIANCE ON MISREPRESENTATIONS CAUSED PAYMENT OF TAXES, PENALTIES AND INTEREST*

44. The Yungs and the '94 Trust are entitled only to those damages directly caused by their reliance on Grant Thornton misrepresentations. To recover the taxes, penalties and interest paid to the IRS on the $30,000,000 that was distributed using the Lev301, the Yungs and the '94 Trust must establish that their reliance on Grant Thornton's misrepresentations directly caused those damages. ―In a professional negligence action [against an accountant for providing bad tax advice], the appropriate measure of damages is the difference between what the taxpayer would have owed absent the negligence, and what they paid because of their accountant's negligence, plus incidental damages." *Lien v. McGladrey & Pullen,* 509 N.W.2d 421, 426 (S.D. 1993). The Yungs and the '94 Trust would not have paid taxes, penalties and interest on a distribution that did not occur. Neither Wytec nor Casuarina was required to make distributions to their shareholders in December of 2000. The court finds that, had Yung not decided to utilize the Lev301 strategy, he would not have authorized the companies to make $30,000,000 in distributions in 2000. The taxes, penalties and interest paid to the IRS are directly attributable to the misrepresentations made by Grant Thornton and relied upon by Yung in entering into the Lev301 transactions. The evidence also shows that the Lev301 distributions could have been unwound for up to two years after they were made and that potentially no taxes would have been owed had this been done. The evidence shows that the Yungs and the '94 Trust were not advised of this by Grant Thornton and so the taxes, penalties and interest are directly attributable to Grant

Thornton's misfeasance including its misrepresentations as to the impact of the January 4th Regulations and its confidence level in its opinion.

45. The evidence shows that Yung was motivated to authorize the Lev301 distributions by the promised tax treatment including the absence of a penalty risk. Accordingly, penalties paid to the IRS that would not otherwise have been owed absent the accountants' misconduct are recoverable as damages in an action against an accountant for malpractice or fraud.

46. As for the interest paid to the IRS by the Yungs and the '94 Trust, whether interest paid to the IRS may be recovered as damages in a tort claim against an accountant when the interest would not otherwise, but for the accountant's tortious conduct, have been paid by the client is a matter of state law. *Ronson v. Talesnick*, 33 F.Supp2d 347 (D.N.J. 1999). While the court was not cited to and has not found a Kentucky case which states directly that interest paid to the IRS may be recoverable under such circumstances as are present here, the general policy of the courts of the Commonwealth as evidenced by the law on the awarding of prejudgment interest supports such an award. Case law supports the general principle that interest shall be awarded on a claim or at minimum that portion of a claim that constitutes an uncontested liquidated amount. "Precisely when the amount involved qualifies as 'liquidated' is not always clear, but in general 'liquidated' means '[m]ade certain or fixed by agreement of parties or by operation of law.' *Black's Law Dictionary* 930 (6th ed. 1990)." *Nucor Corp. v. General Elec. Co.*, 812 S.W.2d 136, 141 (Ky. 1991). "Ordinarily, if the sum due is sufficiently definite so that the tortfeasor has reason to know the amount he should pay or its approximate amount, it would be unjust not to allow interest from the time when he should have made payment." *Restatement (Second) of Torts* § 913, comment on subsection (1), (1979). If the court finds amounts to be have been ascertainable by both parties throughout the action they are liquidated damages. Here the interest

paid to the IRS was a fixed, liquidated amount actually paid which would not have been paid but for the misconduct of Grant Thornton and the misinformation they provided to their client the Yungs. The court concludes that the interest actually paid is a recoverable element of the damages.

B. BY OMISSON

47. Fraud by omission requires a plaintiff to prove by clear and convincing evidence that:

(1) the defendant had a duty to disclose a material fact;
(2) the defendant failed to disclose same;
(3) the defendant‘s failure to disclose the material fact induced the plaintiff to act; and,
(4) the plaintiff suffered actual damages from the action taken.

See, Smith v. General Motors Corp., 979 S.W.2d 127, 129 (Ky. App. 1998).

48. A duty to disclose arises “where a confidential or fiduciary relationship between the parties exists, or when a statute imposes such a duty, or when a defendant has partially disclosed material facts to the plaintiff but created the impression of full disclosure.” *Rivermont Inn, Inc. v. Bass Hotels Resorts, Inc.,* 113 S.W.3d 636, 641 (Ky.App. 2003). A matter is material if “a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question” or “the maker of the representation knows or has reason to know that its recipient is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it.” *Restatement (Second) of Torts* §538.

1. *DUTY OF DISCLOSURE OF MATERIAL FACT*

49. Grant Thornton was in a professional accountant-client relationship with the Yungs and the '94 Trust. This relationship requires confidentiality and full disclosure. This duty to a client is governed and set out in KRS §325.440 (confidentiality of public accounts practicing in Kentucky) and 26 U.S.C. §7225 (state attorney-client privilege to communications with federal tax practitioners); it is also set out in Circular 230 and the standards of practice for Accountants.

2. FAILURE TO DISCLOSE

a. The "listing" omission

50. The failure to disclose the list maintenance requirement is supported by the July 24, 2000, notes of both T. Mitchel and J. Michel and the numerous factual findings of this court. This omission was critical. The casino business, a gaming industry, is a huge part of the plaintiff's business and investments. States tightly control gaming to assure their tax revenue streams and prevent corruption. Grant Thornton was aware of the Yungs' corporate and individual involvement in the gaming industry as a result of their long-term relationship, which included the review and preparation of tax returns and audits for acquisitions. Grant Thornton had in fact solicited Yung to provide its services as a specialist in gaming. The failure to inform Yung and the '94 Trust that Lev301 required list maintenance was tantamount to an assurance that it was not required.

51. The court concludes that Yung would not have participated in the Lev301 strategy if he knew it was a ―list maintenance" item and the omission of this information was material to the inducement to Yung to participate in the Lev301 strategy.

b. The unfavorable opinion by a law firm omission

52. This failure to disclose that an unfavorable opinion existed is intertwined with Grant Thornton's misrepresentations to its agents, on the Client Matrix, that they had an opinion from an internationally respected law firm backing the Lev301 strategy. This misrepresentation and omission was clearly material to the agents in the field, which included not only J. Michel but Williams and other Grant Thornton agents who worked on the various accounts for the Yungs. These agents of Grant Thornton formed opinions based on this information and as professionals could have informed the Yungs of the misrepresentation and omission if they had been aware of it. The court concludes this information was a material fact.

c. The removal of the Lev301 product from the Client Matrix

53. Grant Thornton removed the Lev301 from the Client Matrix on two occasions: in August of 2000 and again in response to the January 4, 2001, regulations. While the court finds that internal actions do not necessarily require disclosure to clients, these particular actions reflected a decision by Grant Thornton to cease marketing and sale of the strategy and, as such, were not a purely internal matter. Grant Thornton issued the engagement letter to Yung in September of 2000 during a period of time when the product was no longer being offered for sale. The court concludes that the Yungs should have been told prior to their signing of the engagement letter that the product was off the market so they could have made their own decision about the risks of the product. In January, at which time Grant Thornton argues they had still not issued an opinion, the Yungs should have been advised that the Lev301 had again been pulled from the Client Matrix and the product was no longer being offered for sale: if the Yungs had been properly advised in August and proceeded with the December transaction this would have been the second notice to them and clearly could have impacted Yung's decision making; if this was

the first notification they received it would have provided an opportunity for Yung to reevaluate the decision and determine whether they were still interested in completing the transactions of the Lev301. In either case, the court concludes this information was a material fact.

d. "Substantial similarity" to BOSS

54. This case presents two very different views regarding the similarity, if any, between Lev301 and BOSS transactions. The testimony of the experts is that the differences are highly technical and subject to debate. Part of the technical debate, as outlined in the Expert section of the Findings of Fact, *supra*, concerns: (1) the interpretation of whether IRC §301 was so clear and unambiguous that IRC §357 could be used to interpret its meaning without impacting its clarity; (2) whether the prohibited BOSS transaction only excluded the creation of a partnership to affect the pass-through of the funds versus the fact that the foreign corporations were existing and viable entities; (3) whether the prohibited tax transaction was only as to gains to corporations not dividends to shareholders; or (4) whether there was a collapse of the steps of the transaction such that its violation of §301 was readily apparent.

55. The omission by Grant Thornton in this matter is their failure to discuss these differing views with Yung. They never informed him that this dividend transfer had a similarity to the BOSS transaction which they differentiated in their opinion because of their view that the language of §301 was so clear and unambiguous that the IRS, by its own rulings and case law, would be prevented from disputing the application of the language of §301 to the Lev301 strategy. They also never informed him that their own ―gut check" by an outside law firm disagreed with their view. The court concludes that this information was a material fact.

3. INDUCEMENT TO ACT

56. Grant Thornton's omissions as outlined above were to assure that Yung would authorize the Lev301 transaction, and did in fact induce Yung to enter into the Lev301 on December 29, 2000, and complete the strategy in August 2001, thus assuring that Yung would pay the fee for the Lev301 of $900,000.00. The court concludes that Yung would not have authorized the use of the Lev301 by Wytec and Causarina if this material information had been disclosed to him.

4. DAMAGES

57. The Yungs and the '94 Trust are entitled to those damages directly caused by Grant Thornton's omissions. Just as with the fraud by misrepresentation, the court concludes that Yung's authorization of the Lev301 distributions caused the Yungs and the '94 Trust to pay taxes, penalties and interest to the IRS that would not otherwise have been owed but for the misconduct of Grant Thornton and the failure to provide proper information to their client the Yungs.

V. PROFESSIONAL NEGLIGENCE

A. STATUTE OF LIMITATIONS

58. Grant Thornton represented the Yungs and the '94 Trust through the settlement of the IRS audit on June 11, 2007. Grant Thornton concealed information from the plaintiffs from July of 2000 through the IRS audit that the Lev301 strategy was required to have a list maintained and that the transaction entered into by the Yungs on December 29, 2000, did not meet the definition of a nonrecourse loan for purposes of §301.

59. The court must first determine if this action by the Yungs and the '94 Trust is barred by the statute of limitations. KRS §413.245 provides:

> Notwithstanding any other prescribed limitation of actions which might otherwise appear applicable . . . a civil action, whether brought in tort or contract, arising out

> of any act or omission in rendering, or failing to render, professional services shall be brought within one (1) year from the date of the occurrence or from the date when the cause of action was, or reasonably should have been, discovered by the party injured.

60. Ironically to this case, in a case named *Michels v. Sklavos,* 869 S.W.2d 728, 730 (Ky. 1994), the Supreme Court of Kentucky interpreted this statute to have ―two separate statutes of limitations: one, a statute limiting to ‗one year from the date of occurrence, ‗ and then a second statute providing a limit of ‗one year. . . from the date when the cause of action was, or reasonably should have been, discovered by the party injured,' if that date is later in time." The courts have further interpreted the ―occurrence provision" to mean that the statute of limitations begins to run when the legal harm suffered by the plaintiff becomes ―fixed and non-speculative." *Alagia, Day, Trautwein & Smith v. Broadbent*, 882 S.W.2d 121, 126 (Ky. 1994).

61. In a malpractice action against a professional to recover monies paid to the IRS pursuant to the settlement of a tax controversy, damages become fixed and non-speculative once a final settlement with the IRS is reached. *Id.*; s*ee also Corporex Companies, LLC v. Proskauer Rose, LLP,* 713 F. Supp. 2d 678, 687 (E.D.Ky. 2010).

62. The Yungs argue that under the discovery rule, when there is fraudulent concealment or a misrepresentation by the defendant as to his role in causing the plaintiff's injury, the statute of limitations is tolled to allow the plaintiff the time to discover the identity of the wrongdoer. *See McCollum v. Sisters of Charity of Nazareth Health Corp.*, 799 S.W.2d 15, 19 (Ky. 1990). Additionally, the Yungs presented the continuous representation rule which tolls the statute of limitations or defers accrual of the cause of action in professional malpractice actions ―while the [professional] continues to represent the client and the representation relates to the same transaction or subject matter as the allegedly negligent acts." See *Gill v. Warren,* 751 S.W.2d 33, 36 (Ky. App. 1988).

63. The court finds that: (1) as Grant Thornton represented many of the Yungs' interests including the continued preparation and review of tax returns; (2) as they had intimate knowledge of the IRS dealing with the Lev301 and other clients which was not disclosed to the Yungs; (3) as they continued to advise the Yungs about the audit process with the IRS; (4) as they also advised them when settlement was appropriate through its agent J. Michel; and, (5) as they interacted with the Yungs and their legal counsel through 2007, that they continuously represented the Yungs relating to the subject matter of the Lev301 and that they fraudulently concealed and misrepresented to the Yungs up and until the IRS settlement on June 7, 2007.

64. The Court concludes that the August 29, 2007, filing of this action was within the one year statute of limitations triggered at the time of the IRS settlement on June 7, 2007.

B. ELEMENTS OF PROFESSIONAL NEGLIGENCE

65. An accountant has a duty to exercise the ordinary care of a reasonably competent accountant acting in the same or similar circumstances. A duty exists where there is an employment relationship between the plaintiff and the defendant/accountant. *Stephens v. Denison*, 64 S.W.3d 297, 298 (Ky. App. 2001).

66. Expert testimony is required to establish the standard of care in a professional negligence case unless the negligence of the professional ~~is~~ so apparent that even a layperson could recognize it." *Boland-Maloney Lumber Co., Inc. v. Burnett*, 302 S.W.3d 680, 686 (Ky. App. 2009). Whether the professional's conduct fell below the applicable standard of care is a question for the trier-of-fact to determine. *Daugherty v. Runner*, 581 S.W.2d 12, 16 (Ky. App. 1978).

67. The tort of professional negligence requires proof of four elements: (1) duty, (2) breach, (3) causation, and (4) damage. *Boland-Maloney* at 686. The existence of duty is a question of

law, while breach and injury are questions of fact. Causation is a mixed question of law and fact. To establish causation, a plaintiff must show that the accountant's negligence was a ―substantial factor in bringing about the harm." *Deutsch v. Shein*, 597 S.W.2d 141, 144 (Ky. 1980). A cause is substantial when the conduct had ―such an effect in producing the harm as to lead reasonable men to regard it as a cause, using that word in the popular sense, in which there always lurks the idea of responsibility..." *Id*.

C. GROSS NEGLIGENCE

68. ―[T]here is very little case law about what constitutes gross negligence with regard to professional negligence. But a finding of gross negligence clearly requires more than a failure to exercise ordinary care. It requires a finding of a failure to exercise even slight care such as to demonstrate a wanton or reckless disregard for the rights of others. *Phelps* [*v. Louisville Water Co.*, 103 S.W.3d 46, 51-52 (Ky. 2003)]. *See also Cumberland Valley Contractors, Inc. v. Bell County Coal Corp.,* 238 S.W.3d 644, 655 n. 33 (Ky. 2007)." *Peoples Bank, supra,* at 268.

D. DUTY

69. Grant Thornton contracted with the Yungs from 1996 until 2007. During that eleven year period Grant Thornton assumed more responsibility for the Yungs' work including preparation, not just review, of tax returns and due diligence for corporate acquisitions. As such Grant Thornton was governed by federal, state and professional rules of conduct all of which included a duty in its representation of the Yungs. Even if Grant Thornton did not have a long term relationship with Yung it had a duty to represent Yung in the sale/purchase of Lev301 in a manner that was consistent with the exercise of that care that is required of a professional selling a tax product which would have included knowledge of the Yungs' businesses, their tax

strategies, their business purposes and a full knowledge of the product that they were presenting for use. They would also be bound by the requirements of Circular 230.

E. BREACH OF DUTY

1. SALE OF THE PRODUCT

70. An accountant is required to adequately advise a client concerning the risks of a transaction and a failure to do so is a deviation from the standard of care. Fritz, the plaintiffs' expert, testified to this standard for accountants practicing in the Northern Kentucky area. The accountant must understand the client's business and the risks specific to that client's business and render advice that is suitable to that risk. Grant Thornton held itself out to Yung as specializing in representations, specifically for IRS audits of gaming corporations. While this representation was made while Grant Thornton was seeking the tax work for the Yungs' gaming entities it was a representation that defined its abilities and professional competency along with specialized areas of expertise. As an expert in the field of casino regulatory issues, Grant Thornton would have known that gaming regulators look closely at an applicant's compliance with tax laws, (PX 826), and that they are concerned with avoidance of any taxes that would be due to the state. The Yungs would have relied on this expertise in making investment decisions.

71. Grant Thornton had reviewed Yung's tax returns for years and as a result would have been aware of the risks that were taken in order to transfer money into the United States for business use. Sara Williams prepared and reviewed tax returns for Yung, both as an employee of Yung and of Grant Thornton. While an employee of Yung she assisted with the review of other tax minimizing strategies and was aware of Yung's risk tolerance for these products. She imparted all of this information to J. Michel once rehired by Grant Thornton and before the Lev301 was presented to Yung.

72. The court concludes that this failure to properly advise the Yungs about the product and about the potential risks to their gaming concerns in the face of Grant Thornton's knowledge of the Yung businesses and gaming business in general was wanton and reckless and a failure to exercise even slight care: in so doing Grant Thornton committed gross professional negligence.

2. THE "MORE LIKELY THAN NOT" OPINION

73. Grant Thornton admitted through Voll that on December 28, 2000, the day Yung executed the first two steps of the Lev301 strategy, the certainty level of their opinion was below ―more likely than not."

74. The execution of the loan, purchase of the Treasury notes and distribution of the notes to the shareholders subject to the loan on December 28, 2000, were distinct acts in the completion of the Lev301 transaction. Hamersley, the plaintiff's expert, testified that these distinct acts were steps in a transaction and if properly analyzed violated the step transaction doctrine. Hamersley also testified that as the distribution was to shareholders this distribution could not sustain a ―business purpose" stated to be liquidity for the acquisition of business property. Hamersley concluded that a reasonably competent federal tax practitioner would not have issued a ―more likely than not" opinion either before or after the January 4, 2001, regulation as the Lev301 violated judicial doctrines, most specifically the step transaction and business purpose doctrines.

75. The court has diagramed the transactional requirements of the Lev301 strategy multiple times and ways, and reviewed several times the testimony of Yale, the defendant's expert, in an effort to understand the posture of Grant Thornton that Lev301 is not a step transaction. The transaction in its simplest components breaks down into steps. The court finds and concludes as the trier of fact that based on the expert testimony of Hamersley, the overwhelming evidence of

concern regarding these two doctrines in Grant Thornton's e-mails, and the necessary steps of the financial transactions necessary to accomplish the Lev301, that Lev301 was a step transaction. As such it violated judicial doctrines even before the January 4, 2001, regulations were passed. Hamersley testified that after January 4, 2000, as the loan documents for the Lev301 were recourse, Grant Thornton's legal arguments in support of the strategy were frivolous. The court adopts the conclusions of plaintiff's expert Hamersley.

76. The failure of Grant Thornton to recognize Lev301 as a step transaction that was not viable on December 28, 2000, was not only a failure to exercise ordinary care it was a failure to exercise even slight care and demonstrates a wanton and reckless disregard for the rights of the Yungs. Grant Thornton's failure to recognize that the Lev301 was not legally supportable on December 28, 2000, and thereafter and their failure to so advise the Yungs was a failure to exercise even slight care and demonstrates a wanton and reckless disregard for the rights of the Yungs. The court concludes that Grant Thornton thereby committed gross professional negligence.

3. TAX RETURNS

77. Fritz testified that a reasonably competent accountant practicing in the Northern Kentucky area has a duty to maintain objectivity when rendering professional services for his or her client. This duty includes advising clients of the risk of penalties when preparing a return.

78. Grant Thornton prepared and reviewed the 2000 and 2001 federal income tax returns for the '94 Trust and reviewed the 2000 and 2001 federal income tax returns for the Yungs. Grant Thornton had solicited the Yungs for many years to act as its tax preparer. Even after Williams left CSC and returned to Grant Thornton she assisted with the preparation of their tax returns. Williams testified that she sought the advice of J. Michel in preparing the tax returns. J. Michel

in several e-mails had made it very plain how the transaction should appear on the tax returns to assure that there were no hints to the IRS that a Lev301 transaction had occurred. Which is ironic in light of the fact that Grant Thornton had prepared a list of Lev301 clients for the IRS should they ask.

79. This collaboration by Williams and J. Michel failed to meet the objectivity standard required by a professional accountant. The failure to report exposed both the Yungs and the '94 Trust to penalties. Because of J. Michel's control over William's tax preparation and Grant Thornton's preparedness for an audit of Lev301, along with Grant Thornton's misrepresentation to these agents that the strategy was supported by an outside legal opinion, the court finds that Grant Thornton failed to exercise even slight care which demonstrates wanton and reckless disregard for the rights of the Yungs and concludes that Grant Thornton thereby committed gross professional negligence.

4. UNWINDING THE TRANSACTION

80. An accountant is required to adequately advise a client concerning the risks of a transaction and a failure to do so is a deviation from the standard of care.

81. There was evidence at trial that this transaction could have been unwound so as to negate its occurrence for tax purposes even though Grant Thornton would still have been required to maintain a list. There was evidence that Grant Thornton had researched and prepared a memorandum on the issue of rescission. Voll testified that there were provisions for rescission in the IRC. This court cannot conclude that unwinding or rescinding of the Yungs' Lev301 was a probability.

82. However, in January 2001 when Marquet inquired, in response to the January 4th regulations and Grant Thornton's failure to issue the promised final formal Opinion Letter on

January 15th, whether the loans should be paid off to stop the interest expense or if Grant Thornton would pay the interest if the deal never finalized as planned, it was the obligation of J. Michel or another agent of Grant Thornton to advise the Yungs as to the effect of this legitimate course of action. (PX 1042). Instead, a draft of the final formal Opinion Letter was e-mailed to Marquet.

83. Marquet's solution was not an unwinding of the strategy but would have resulted in an accelerated completion of the Lev301 as the Treasury notes would have been distributed to the shareholder. For the transaction to be unwound the shareholders would have been required to transfer their ownership of the treasury notes to the purchasers, Wytec and Causarina. Both of these actions would have had tax consequences.

84. Grant Thornton's failure to objectively advise the Yungs, regarding the January 2001 inquiry, to pay the interest and or unwind the transaction demonstrated the exercise of less than slight care such that its behavior was wanton and reckless in disregard of the rights of the Yungs. The court concludes that Grant Thornton committed gross professional negligence.

5. FAILURE TO DISCLOSE

85. In 2002 the IRS initiated its examination of Grant Thornton regarding its tax shelter products. This examination was aimed at the Lev301 product. The audit was handled by a small group of Grant Thornton agents which included Stutman. The evidence is clear that Stutman was aware of Lev301 and the tax concerns about this product and specifically about the Yung transactions. Stutman was also aware of the Yungs' sensitivity to risk because of their gaming businesses. This IRS examination substantially increased its client's risk of being audited for the Lev301 – especially as they had a ready-made list of clients ready to turn over to the IRS – and the client's risk of reputational injury.

86. A reasonably competent accountant practicing in the Northern Kentucky area has a duty to maintain objectivity and to advise of risks when rendering professional services for his or her client. Grant Thornton had a duty to inform the Yungs that the product they purchased and used was being audited and scrutinized. The Yungs could then have been advised to determine the solutions available and the risks associated with each solution. The Yungs were never advised of the option to revise tax returns to report the Lev301 which could have diminished penalties and interest. This audit also increased the sensitivity risk of this transaction to the gaming industry and thus to Yung's business interests and reputation.

87. Grant Thornton's failure to objectively advise the Yungs regarding the IRS audit into Lev301 demonstrated the exercise of less than slight care such that its behavior was wanton and reckless in disregard of the rights of the Yungs and the court concludes that Grant Thornton committed gross professional negligence.

F. CAUSATION

88. The negligence of Grant Thornton must be the cause of the damages to the Yungs for those damages to be recoverable. In this case the damages are the payment of taxes, penalty, interest, and the loss of reputation of Yung.

89. Yung would not have considered the Lev301 transaction in July or contracted for it in September if: (1) he was told in July of 2000 of the apparent similarities to the BOSS transaction, as he had already declined to invest in those types of transactions, (2) he was told of the list maintenance requirement, and/or (3) he was told that the product had not reached the certainty level of ―more likely than not" and was not fully vetted.

90. The Yungs would not have entered into the Lev301 in December of 2000 if they knew: (1) the December 28th opinion letter was not issued at the certainty level of ―more likely than

not", and/or (2) the stated ―business purpose" was being questioned as sufficient by Grant Thornton.

91. The Yungs would have considered options regarding the reporting or unwinding of the Lev301 if they had been fully advised of the effect of the January 4, 2001, regulations once those were issued.

92. The Yungs would have considered reporting the Lev301 transaction on their tax returns if they were notified that the Lev301 product they purchased was under scrutiny by the IRS.

93. Grant Thornton had a multitude of opportunities, both small and large, throughout its relationship with the Yungs to advise them about all of the risks and concerns surrounding the purchase and use of the Lev301. Instead Grant Thornton chose to misinform, misadvise and fail to advise its agents and its client the Yungs.

94. The court finds that each of these acts of gross professional negligence, singularly and as a course of conduct, was a substantial factor in causing the harm and damages to the Yungs in the form of taxes, interest, penalty and reputational loss.

VI. DAMAGES

A. LEV301 ENGAGEMENT FEE

95. The $900,000 engagement fee was paid in full to Grant Thornton pursuant to the terms of the engagement letter. (Trial Tr. 218:21-218:22 (W. Yung Test.)).

96. But for Grant Thornton's false representations regarding the Lev301 product at the July 5th and July 24th meetings, Yung would not have entered the engagement in the first place. The Yungs would not have had to pay the $900,000 fee had Grant Thornton not been negligent in advising Yung to utilize the Lev301 strategy, per the terms of the Final Engagement Letter.

97. Accordingly, Yung is entitled to recover the full amount of the $900,000 fee.

B. TAXES, PENALTIES, AND INTEREST PAID TO THE IRS BY THE YUNGS AND THE '94 TRUST

98. The actual amount in taxes, penalties and interest owed by the Yungs to the IRS pursuant to their settlement agreement is as follows: $2,912,243 in taxes; $395,543 in penalties; and $475,000 in interest. The amount paid by the Yungs was reduced by refunds due in connection with the CSC audit that Yung would have received regardless of the Lev301. (PX 492; Trial Tr. 2504:10-2509:16 (T. Drake Test.)).

99. The amount paid by the '94 Trust to the IRS pursuant to the settlement agreement is as follows: $8,925,617 in taxes; $1,160,330 in penalties; and $4,546,494 in interest. (PX 1438; PX 1439).

100. But for the Yungs and the '94 Trust's participation in the Lev301 transactions, they would not have paid the taxes, penalties and interest they paid in connection with the IRS settlement agreement.

101. Accordingly, Yung and the '94 Trust are entitled to recover the full amount of the $18,415,227 in taxes, penalties and interest paid.

C. SETTLEMENT OF PRESIDENT CASINO'S BREACH OF CONTRACT CLAIM

102. The court directed a verdict for Grant Thornton regarding the gaming damages as the casino corporations were not a party to this action. The court found as a result that, while damages associated with the casinos were not recoverable, Yung's reputational issue as a shareholder who failed to report income and as a ―key person" who failed to report income could be considered by the court in its assessment of the damages caused by the actions of Grant Thornton.

103. In late 2004, WTC acquired President Casino for $60,000,000 at a bankruptcy auction. (Trial Tr. 244:2-18 (W. Yung Test.)).

104. To complete the acquisition, Yung was required to obtain a key person license from the Missouri Gaming Commission (―MGC") because of his status as WTC's sole shareholder. (Trial Tr. 244:19-245:8 (W. Yung Test.)). Pursuant to the purchase agreement with President Casino, Yung was to use reasonable efforts to obtain a license.

105. As part of the application process, Yung disclosed the IRS audit of his participation in the Lev301 to the MGC staff. (Trial Tr. 248:1-16, 249:12-14, 250:25-251:16 (W. Yung Test.)).

106. In September of 2005, Steve Johnson, who was the director of enforcement for the MGC, informed Yung that the MGC staff would recommend that the MGC deny his license. (PX 648; Steve Johnson Dep. 21:16-22:14, Dec. 16, 2011). Yung's participation in the Lev301 was a substantial factor in the MGC staff's decision to recommend a denial. (PX 642; PX 644; Johnson Dep. 124:9-124:15; Trial Tr. 256:6-11 (W. Yung Test.)).

107. Fearing that a denial by the MGC would impact his casino licenses in other jurisdictions, Yung withdrew his application. (Trial Tr. 259:7-23, 264:20-24 (W. Yung Test.)). Yung's decision to withdraw was commercially reasonable.

108. As a result of Yung's failure to acquire a license from the MGC, he could not complete his purchase of the President Casino. (Trial Tr. 265:12-22 (W. Yung Test.)).

109. President Casino then instituted a claim for breach of contract against WTC and CSC in the Bankruptcy Court for the U.S. District Court for the Eastern District of Missouri. (Trial Tr. 265:20-266:3 (W. Yung Test.)).

110. After several years of litigation, the parties settled the breach of contract action (―President Settlement") on December 23, 2010. (PX 666). Pursuant to the President Settlement, CSC and WTC were to pay $20,500,000, which Yung personally guaranteed. (Trial Tr. 265:20-266:3 (W. Yung Test.); PX 666). As of the date of this trial, the settlement had been

paid in full through the retention of the $1,500,000 deposit made at the time of contract, and in five additional installments paid on December 30, 2010, ($10,000,000); January 31, 2011, ($5,000,000); April 1, 2011, ($2,000,000); April 29, 2011, ($1,000,000); and May 18, 2011, ($1,000,000). (PX 667; Trial Tr. 2518:12-2520:9 (T. Drake Test.)).

111. The substantial factor in causing Yung to withdraw his license application in Missouri was the MGC staff‟s reaction to the Lev301 tax shelter. Because the other issues were insubstantial, Yung would have proceeded with his license application in Missouri but for the Lev301. Had he proceeded with his license application, the breach of contract action brought by President would not have been initiated. However, the court still finds these compensatory damages not to be personal to Yung but to be damages to a corporation not a party to this action. To the extent this prevented Yung from continuing to act in the role of key person for new casinos it caused reputational damage that is personal to him.

VII. PUNITIVE DAMAGES

112. Kentucky recognizes claims for punitive damage. KRS §411.184(1)(f) defines punitive damages as those ―other than compensatory and nominal damages, awarded against a person to punish and to discourage him and others from similar conduct in the future." *See also Peoples Bank*, 277 S.W.3d at 267, ―Punitive damages are given to the plaintiff over and above the full compensation for his injuries, for the purpose of punishing the defendant, teaching him not to do it again, and deterring others from following his example." This right is protected by the Kentucky Constitution. KRS §§411.184 through 411.186 provides guidelines for the assessment and awarding of punitive damages. *Kentucky Dept. of Corrections v. McCullough*, 123 S.W.3d 130, 139 (Ky. 2003).

113. In a bench trial, the award of punitive damages is entirely within the discretion of the trial court as fact-finder in the case. *Faulkner Drilling Co., Inc. v. Gross*, 943 S.W.2d 634, 639 (Ky. App. 1997). An assessment of punitive damages is appropriate when a plaintiff proves by clear and convincing evidence that the defendant acted fraudulently or was grossly negligent in injuring the plaintiff. *See, KRS* §411.184(2) and *Williams v. Wilson*, 972 S.W.2d 260, 264 (Ky. 1998).

114. Once the trier of fact determines the defendant acted fraudulently or was grossly negligent five factors should be considered and weighed to assess the damages. KRS §411.186(2):

> (a) The likelihood at the relevant time that serious harm would arise from the defendant's misconduct;
> (b) The degree of the defendant's awareness of that likelihood;
> (c) The profitability of the misconduct to the defendant;
> (d) The duration of the misconduct and any concealment of it by the defendant; and
> (e) Any actions by the defendant to remedy the misconduct once it became known to the defendant.

A punitive damage award must be reasonable to be in conformity with due process. *BMW North America, Inc. v. Gore*, 517 U.S. 559, 582-583 (1996).

A. FRAUD – MISREPRESENTATION

115. The court has already determined that Grant Thornton acted fraudulently in its position of trust with the Yungs. *See* Conclusions of Law §IV(A) Fraud. Grant Thornton has argued that all of the e-mail correspondence and communications merely show a healthy internal debate about the impact of tax rules and regulations on the Lev301. The court has already found that the e-mail correspondence and communications evidenced fraud. The court now determines that the fraud by misrepresentation was proven by clear and convincing evidence and not just by a preponderance of evidence because of: (1) Grant Thornton‘s deliberate decisions to manipulate

the language in their ―worst-case scenario" representation and the multiple agents, including Jorgensen, who continued to mislead the Yungs on this issue; and (2) Grant Thornton's continual and obvious misrepresentation by J. Michel that ―it's all good" concerning the January 4th regulations. Additionally, the clear misrepresentation by Grant Thornton to its own agents that this strategy was supported by an independent legal opinion, and by the misleading January 10th e-mail and the March 5, 2003, J.Michel letter to the IRS concerning IRD-6. (PX 1365).

116. The infliction of economic injury is clear in this case not only as to the taxes, interest and penalties but as to the reputation of Yung individually as a business person and as a shareholder, especially when done intentionally through affirmative acts of misconduct. Therefore these actions can warrant a substantial penalty. *See BMW,* 517 U.S. at 576.

B. FRAUD – OMISSION

117. The court has already determined that Grant Thornton's actions were fraudulent by omission in its position of trust with the Yungs. *See* Conclusions of Law §IV(B) Fraud.

118. The court now determines that fraud by omission was proven by clear and convincing evidence and not just by a preponderance of the evidence, because:

1) The list maintenance omission was intentional and obvious and thus egregious and from the December 29th transaction forward caused an enormous detriment to the business entities, the shareholders and Yung personally;

2) The failure to disclose even to J. Michel that there was no favorable opinion from an independent law firm was obvious and intentional and thus egregious and others, including Williams or other agents of Grant Thornton, could have revealed this had they known of it. The failure to notify Yung regarding the unfavorable attorney opinion was gross negligence;

3) The failure to properly identify the loan as recourse was gross negligence, the failure to notify the Yungs when the recourse issue was discovered was gross negligence, the failure to check the documents and notify the Yungs of this problem after the January 4th regulation was gross negligence, the actions of Grant Thornton in seeking assurance through other channels that the loan was nonrecourse without notifying the Yungs was gross negligence;

4) The failure to notify Yung of the removal of the Lev301 from the Client Matrix was gross negligence;

5) The failure to advise Yung about the possibility of unwinding the transaction was gross negligence.

These were clearly and obviously omissions known by Grant Thornton and its agents which could easily have been transmitted to Yung but which were not. The infliction of economic injury is clear as to the taxes, penalties and interest and as to the reputational damage to Yung individually as a business person and as a shareholder.

C. GROSS PROFESSIONAL NEGLIGENCE

119. The court has already determined that Grant Thornton acted with gross negligence in its professional representation of the Yungs. See Conclusions of Law §IV(B). In Kentucky, “the recovery of punitive damages for grossly negligent conduct was a recognized common law right which predated the 1891 Constitution.” *Williams v. Wilson*, *supra*, at 264-265. Accordingly, the Kentucky Supreme Court has held that punitive damages may be awarded on a showing of gross negligence and that “KRS §411.184 cannot constitutionally exclude recovery of punitive damages [based on the absence of fraud, oppression, or malice].” *Peoples Bank*, 277 S.W.3d at 267, citing *Williams* at 264.

120. There were so many acts of gross professional negligence committed by Grant Thornton, including its ongoing Circular 230 tax preparer failures to advise regarding tax returns and disclosure requirements and its consultation misrepresentations regarding audits and settlements, the court finds that it was proven by clear and convincing evidence. The court finds that an assessment of punitive damages will deter Grant Thornton and its agents from similar reckless and wanton behavior in the future.

D. DAMAGE ASSESSMENT

121. To assess punitive damages, the five factors listed in KRS §411.186(2) must be considered and the award must be reasonable utilizing three constitutional guideposts. *See Snyder*, supra at 2, (Knopf, J. concurring), and *BMW,* 517 U.S. at 582-583 (relied on by *Ragland v. DiGiuro*, 352 S.W.3d 908, 916 (Ky. App. 2010)).

122. The factors the court must weigh in determining the amount of damages to be assessed are outlined in KRS §411.186(2) and set forth above in §VI Punitive Damages ¶92. These factors were approved for determination of punitive damages by the Kentucky Supreme Court in *Sand Hill Energy, Inc. v. Smith*, 142 S.W.3d 153, 167 (Ky. 2004).

1. The Likelihood at the Relevant Time That Serious Harm Would Arise From the Defendant's Misconduct

123. The court has outlined in several sections of this opinion that serious harm would and did arise from Grant Thornton not fully informing the Yungs of the risks of the product, most notably the fact that the December 28, 2000, opinion letter was not supported by a ―more likely than not" confidence level. The possibility of serious harm was increased by the fact that the Yungs' primary business consists of hotels and casinos which are subject to higher financial and personal scrutiny. The factors in the environment surrounding tax minimizing and eliminating products in the time frame beginning in January 2000 made the use of the Lev301 product a

game of audit roulette. Thus the likelihood of serious harm arising from these acts of misconduct and gross negligence were very apparent.

2. The Degree of the Defendant's Awareness of that Likelihood

124. The court has outlined the awareness of all of the members of Grant Thornton. Grant Thornton was aware of the likelihood of this harm because its agents were specialized in ―business purpose", the gaming industry, and foreign corporations; and through their trusting fiduciary relationship had a thorough knowledge of Yung's business and his reputational concerns.

3. The Profitability of the Misconduct to the Defendant

125. The Yungs' transactions were the first to be solicited by Grant Thornton and the Opinion was the model for the vetting of all of the Lev301 strategy tax issues. Grant Thornton received $900,000.00 from the Yungs. They sold the Lev301 to a number of other entities based on that model opinion. That the financial transaction had to be vetted to assure that it was a nonrecourse loan was also fully realized because of the Yung loan and note documentation.

126. The Lev301 was developed to compete with the larger accounting firms who used this type of product to capture the relationship with clients like the Yungs. Thus, the Lev301 was not only a product of significance itself it was used to prove competence and depth of service to Grant Thornton's current client list and increase its level of retention. The Yungs are an example of this strategy. Grant Thornton was contracted after the Lev301 transactions to prepare tax returns for the Yungs as well as review them for the Trust, thus Grant Thornton's dealings with Yung were expanded. This position was then used to misadvise the Yungs about disclosure requirements of these transactions to the IRS, which also increased the sale-ability timetable to other Grant Thornton clients.

127. There was no evidence presented as to the profitability of this product and such evidence would have been improper. *See, e.g., Hensley v. Paul Miller Ford*, 508, S.W.2d 759, 764 (Ky. 1974), and *Givens v. Berkley*, 108 Ky. 236, 56 S.W. 158 (1900). The court can consider that concealing the flaws in the Lev301 strategy allowed the product to be seen as successful by the clients and agents at Grant Thornton. This enhancement of reputation of the product by concealment allowed Grant Thornton to, for at least a time, avoid a public relations disaster and maintain and increase its revenue base.

4. The Duration of the Misconduct and any Concealment of it by the Defendant

128. The court has outlined the misconduct and concealment beginning with the July meeting and continuing through the audit and settlement. Most troubling is the discovery in this case which reveals that Grant Thornton continued to conceal evidence of its misconduct up to the trial of this case which was held twelve years from the original sales meeting, including the concealment of their misconduct from their other clients.

5. Any Actions by the Defendant to Remedy the Misconduct once it Became Known to the Defendant

129. There was no attempt by Grant Thornton to remedy the actions in the matter. From July 2000 until December 28, 2000, Grant Thornton could and should have told Yung of the list maintenance requirement, their business purpose weakness, the adverse opinion of independent legal counsel, and have advised them of the risks to a gaming entity. On December 28, 2000, Grant Thornton could and should have declined to give an opinion to the Yungs. On January 5th and for months thereafter Grant Thornton could and should have told the Yungs that their "business purpose" was weak, that the January regulations made the Lev301 more risky not less, and that the transaction documents were recourse and thus the transaction was fatally flawed. All of this could and should have been shared with the Yungs all the way through August 2001

when Grant Thornton argues it first issued the ―more likely than not" Opinion Letter. Instead, Grant Thornton never fully advised the Yungs of the risks of this transaction at any stage of its development or as it was affected by various tax regulations and tax changes. Most shocking is Grant Thornton's violations of Circular 230 in the ongoing preparation of the Yungs' tax returns and their willing misrepresentations to the IRS regarding the Yung transactions.

130. The court finds, in consideration of the five factors of KRS §411.186(2), that the facts support an assessment of punitive damages in the sum of $80,000,000.

E. CONSTITUTIONALITY

131. The U.S. Supreme Court set forth three guideposts to determine whether an award was in conformity with due process: ―(1) the degree of reprehensibility of the defendant's conduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the civil penalties authorized or imposed in comparable cases." *State Farm Mutual Automobile Insurance Co. v. Campbell*, 538 U.S. 408, 418 (2003).

1. The Degree of Reprehensibility of the Defendant's Conduct

132. This component of determining the constitutionality of an award has a five part factor analysis.

(1) Whether the harm caused was physical as opposed to economic;
(2) Whether the tortious conduct evidenced an indifference to or a reckless disregard for the health or safety of others;
(3) Whether the target of the conduct had a financial vulnerability;
(4) Whether the conduct was repeated as opposed to an isolated incident; and
(5) Whether the harm resulted from intentional malice, trickery, deceit, or accident.

State Farm at 419. The existence of only one of these factors may be insufficient to support a finding of reprehensibility. *Id*. And the absence of all of these renders a punitive award suspect. *Id*.

133. The first three factors are not implicated in this case. Regardless, the infliction of an economic harm can still merit a substantial penalty. *See BMW,* 517 U.S. at 576; *and see TXO Production Corp. v. Alliance Resources Corp*., 509 U.S. 443, 468-469 (1993) (in upholding the punitive damages claim, Justice Kennedy, concurring in part, wrote ―I cannot say with sufficient confidence that the [$10 million punitive award on $19,000 compensatory damages] was unjustified or improper on this record…the evidence at trial demonstrated that [the defendant] acted…through a pattern and practice of fraud, trickery and deceit and employed unsavory and malicious practices in the course of its business dealings with the [plaintiffs].”). Consideration of the record in light of the fourth and fifth factors supports a finding that Grant Thornton‘s conduct was sufficiently reprehensible.

a. The repetition of the misconduct

134. Grant Thornton‘s misconduct was not isolated to one incident but was varied and repeated beginning in July 2000 through 2007, and arguably through the date of trial. The misconduct was direct in the most severe of circumstances but Grant Thornton also acted in indirect ways that adversely affected the Yungs. The court may consider conduct beyond that visited directly upon the plaintiff in determining the degree of reprehensibility. *See Kentucky Farm Bureau Mutual Ins. Co. v. Rodgers*, 179 S.W.3d 815, 819 (Ky. 2005) (quoting *State Farm*, 538 U.S. at 422-424, ―our holdings that a recidivist may be punished more severely than a first offender recognize that repeated misconduct is more reprehensible than an individual instance of malfeasance”). Such a review comes with caveats. The U.S. Supreme Court

instructed that, “Lawful out-of-state conduct may be probative when it demonstrates the deliberateness and culpability of the defendant‘s action in the state where it is tortious, but that conduct must have a nexus to the specific harm suffered by the plaintiff.” *State Farm*, 538 U.S. at 422-424, *and see Rodgers*, 179 S.W.3d at 820 (disallowing review of other acts in insurance bad faith case where no bad faith claim was filed by other insureds and the claim involved a different adjuster). A defendant may not be punished for conduct that was lawful in the jurisdiction in which it occurred. To be clear, other parties‘ potential claims against a defendant, especially if those hypothetical claims stem from conduct outside the state of Kentucky, may not be “adjudicated” by being factored into the punitive damages calculation. *Sand Hill*, 142 S.W.3d at 156-157 (citing *State Farm*, 538 U.S. at 420-423).

135. Evidence of a defendant‘s conduct occurring outside Kentucky may be considered “in determining whether [the defendant‘s] conduct occurring in Kentucky was reprehensible, and if so, the degree of reprehensibility.” *Sand Hill,* 142 S.W.3d at 165-167 (quoting a portion of sample instructions provided by the Kentucky Supreme Court when remanding for a new punitive damages determination, noting the instructions “provide[] a safeguard from extraterritorial punishment” in consideration of the recent *State Farm* decision).

136. Grant Thornton‘s obvious and egregious repeated misconduct against the Yungs and the ‘94 Trust occurring solely within the state of Kentucky is sufficient for a finding of reprehensibility. Plaintiffs‘ expert Donald Fritz testified to numerous scenarios that reflected fact situations in which Grant Thornton failed professionally and violated tax advisors‘ standards of care. (Trial Tr. 2198–2314 (Fritz Test.)). Additionally, the facts support a finding of numerous affirmative misrepresentations and fraudulent omissions by Grant thornton regarding the Yungs‘ and the ‘94 Trust‘s transactions across many years.

137. Additionally, there is a connection between the harm suffered by the Yungs and that suffered by other Grant Thornton Lev301 clients that warrants consideration in determining the damages of the Yungs.

138. The Lev301 was created by Jorgensen and developed at the NTO, a centralized group in D.C. that was responsible for tax products. Grant Thornton also rolled out the Lev301 to its regional offices by presenting a uniform marketing strategy and introducing centralized product resources such as a product champion, product manager, and technical champion. (PX 20).

139. As Product Champion, J. Michel contributed to all Lev301's. (*See, e.g.,* J. New Dep. 84:16-21, March 21, 2012). Like the Yungs and the '94 Trust, all Lev301 purchasers were subjected to Grant Thornton's list maintenance, and nearly all were subsequently audited by the IRS for participation in the strategy. (*See id*. at 91:9-14). Similar to the Yungs' audit, J. Michel, with support from Frishman, was involved in other Lev301 clients' audits. (*Id*. at 91:12 – 92:1). In the case of Lev301 client James New, Grant Thornton continued to champion the strength of the Lev301 product as late as November 2005, despite having removed the product from the Client Matrix a year earlier. (*Id*. Mr. New recorded in his notes from November 1, 2005, ―John [Michel] to talk with DC partner Jeffrey Fishman [*sic*] and come up with plan for all clients. Again said we were not a 99-59 transaction. Feels opinion extremely strong, wide open loophole, never closed by the IRS.")

140. A common nexus between all of the other Lev301 clients and the Yungs is the evidence that the Wytec and Casuarina opinions served as the model opinion for future Lev301 clients. (*See* PX 1167). This fact exposes the deliberateness of Grant Thornton's cover-up and omissions because in June of 2001, Voll changed the Lev301 after issues regarding the recourse nature of the obligations surfaced. Grant Thornton realized it could not advise on the recourse

nature of the loans and attempted to get representations regarding the obligations from other clients going forward. But it never revisited the Yungs‘ and Trust‘s Lev301 transaction, despite Voll‘s testimony that, at that time, the transactions could have been unwound. (Voll Dep. 288:14-290:15, Nov. 8, 2011; Voll Dep. 645:16-646:20, March 15, 2011).

b. Harm from intentional malice, trickery or deceit

141. A punitive award can be justified by the level of fraud, malice and/or deceit perpetrated by a business. *See BMW, supra,* 517 U.S. at 576 (citing *TXO*, 509 U.S. 468-469 (Kennedy, J. concurring)).

142. Deceitful conduct and malice are evident both before and after the Lev301 transaction. First, substantial risks were withheld from the Yungs and their agents while simultaneously Grant Thornton discussed the gravity of such risks internally. (*Compare* PX 28 *with* PX 29, *see also* PX 20 at G007357-0031). Indeed, when deciding to move forward with the Lev301 in spite of the new list maintenance requirements, J. Michel reflected on the relatively small penalty to Grant Thornton in light of the potential fees – never considering the potential harm to the client. (PX 29; Trial Tr. 3667:10–13 (J. Michel Test.)). Equally reprehensible is the recognition by Grant Thornton that the Lev301 had ―a short shelf-life" and thus it was necessary to fast-track sales without regard to details or the product‘s validity. (PX 1023; Trial Tr. 3688:13–3689:7 (J. Michel Test.)).

143. The deceit of J. Michel‘s January 10, 2001, statement assuring the Yungs that the January 4th regulations strengthened the Lev301 is substantial and apparent when viewed in light of the e-mails, the notes, and the testimony of other Grant Thornton partners concerning the issuance of the January 4th regulations. The evidence in this case is overwhelming that the release of the January 2001 regulation caused Grant Thornton, especially the NTO opinion writers and

researchers, great business anxiety and concern regarding the Lev301. (*See* PX 60). Accordingly, Ben Horak suspended the sale of the Lev301 the very next day and instructed the partnership to advise clients of the issue. (PX 61). The desperateness of the situation is evident in the exchange between Horak and Stutman. (PX 891). Yet on January 10, 2001, J. Michel intentionally misrepresented the impact of the regulations and the concern of the partnership in an effort to ―buy time." (PX 64, PX 1267). The court finds J. Michel's subsequent testimony, that he was simply communicating the status of Grant Thornton's position to his client, is not credible as it is belied by the testimony of others and the weight of the documented evidence in the record. (Voll Dep. 836:7-21 (March 15, 2012); PX 523).

144. Together, the factors of repetition of the conduct and maliciousness/deceitfulness of the conduct support a finding of reprehensibility.

2. The Disparity Between the Actual or Potential Harm Suffered by the Plaintiff and the Punitive Damages Award (Ratio)

145. The most commonly cited indication of an unreasonable punitive award is its ratio to the actual harm inflicted on the plaintiff. *Ragland*, 352 S.W.3d at 918. This second guidepost combines a subjective analysis, incorporating Kentucky's ―first blush" rule, with a more objective analysis. *See id.* at 918 – 919.

146. Kentucky's first blush rule is inherently subjective and, consequently, different courts may reach different results. *Id.* at 919 Accordingly, the first blush test is valuable only as a starting point and is to be supported by an objective application of the analysis in order to merit an award reduction. *Id*.

147. In applying the objective analysis, there is no mandated ratio, the exceeding of which makes any award unconstitutional. But the U.S. Supreme Court noted that ―few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant

degree, will satisfy due process." *State Farm*, 538 U.S. at 425. A punitive damage award that is ―‗more than 4 times the amount of compensatory damages' … ‗might be ―close to the line,"' and perhaps …‗cross the line into the area of constitutional impropriety.' *BMW of North America, Inc. v. Gore,* 517 U.S. 559, 581 (1996) (citing *Pacific Mutual Life Insurance Co. v. Haslip,* 499 U.S. 1, 23-24 (1991).)" *Ragland v. DiGiuro*, *supra*. *But see, Roman Catholic Diocese of Covington v. Secter*, 966 S.W.2d 286 (Ky. App. 1998) (upholding a 14 to 1 ratio); *Rodgers*, 179 S.W.3d at 828 (Wintersheimer, J. joined by Justices Scott and Lambert dissenting, stating, ―As it stands now, the ratio imposed is roughly 11 to 1. This ratio may seem high to some, however, the degree of reprehensibility and the pattern of bad faith does support the ratio imposed as reasonable." Majority reversed appellate court on separate grounds); and *Modern Management Company v. Wilson*, 997 A.2d 37 (D.C. 2010) (11 to 1 ratio upheld in sale/lease-back scheme because of deceitful conduct).

148. When determining the ratio, ―[i]t is appropriate to consider the magnitude of the *potential harm*[.]" *TXO Production Corp, supra,* at 460 (emphasis in original); and see *Gore*, 517 U.S. at 583. Accordingly, there should be a reasonable relationship between the punitive award and ―*the harm likely to result* from the defendant's conduct as well as the harm that actually has occurred." *Id*. (emphasis in original); and see *Craig & Bishop, Inc. v. Piles*, 247 S.W.3d 897, 907 (Ky. 2008) (upholding the punitive damages award of an approximately 6:1 ratio where, ―compensatory damages could have been much higher if *the facts had been slightly different*" (emphasis added)).

149. Compensatory damages from the transaction itself, excluding pre-judgment interest, amount to $19,315,227 for taxes, penalties, interest and the fee. The likely consequences of misleading a casino owner who is a ―key person" in that industry into a possibly abusive tax

shelter, a situation Grant Thornton was well aware of, are substantial collateral damages possibly in the hundreds of millions of dollars and potentially crippling. The reputational loss to Yung personally caused substantial difficulties within the gaming industry with the continuation of his growing casino business. The court determines that punitive damages in the amount of $80,000,000 is appropriate and represents an approximate four to one ratio with compensatory damages, and significantly lower than that when taking into consideration potential harm, particularly from the damage to Yung's individual reputation.

3. Sanctions for Comparable Misconduct

150. A third guidepost is comparing the punitive award and the civil or criminal penalties that could be imposed for similar misconduct. *BMW*, 517 U.S. at 583. Substantial deference should be given to legislative judgments concerning appropriate sanctions. *Id*.

151. In *Craig & Bishop,* 247 S.W.3d at 907-908, the Kentucky Supreme Court noted the potential penalties for fraudulent activities. It determined the punitive damages award was not excessive considering ―the possible civil or criminal penalties [that] could have been imposed if allegations had been sufficiently proven for those types of hearings (*i.e.*, beyond a reasonable doubt for criminal offenses such as theft), including loss of the license to sell motor vehicles for false advertising, defrauding buyers, or other grounds[.]" *Id*. at 906.

152. Mark Stutman of Grant Thornton testified about the sanctions levied in the accounting industry for involvement with tax shelters:

> [The overall environment] would have been Congress's perception of the tax shelter arena. It would have been the IRS's action in terms of contesting tax shelters.
>
> Certainly, we did not look at [Lev301] as a tax shelter, in the same vein as gain eliminators or some of the other things that ultimately put the entire firm of KPMG at risk of surviving. …
>
> [The overall environment] was an issue – an area of concern because of all the things happening around us, including,

> ultimately, the implosion of Jenkins & Gilchrist as a law firm, now of Brown & Wood as a law firm.
>
> So all of those things were sort of out there in the environment.

(Stutman Dep. 205:5-23, Nov. 10, 2011).

153. Penalties in the hundreds of millions of dollars, such as those levied against KPMG, could have been imposed if allegations had been sufficiently proven by the documents produced to the IRS by Grant Thornton. Short of the IRS dismantling Grant Thornton, many of the partners involved in the Yungs' and Trust's transaction could have had their law and/or accounting licenses suspended for the fraudulent acts against their clients.

154. Thus, review of the exemplary award of $80,000,000, a figure arrived at after considering the factors under KRS §411.186(2), does not prove excessive under the three constitutional guideposts. It remains appropriate as both a punishment and a deterrent for reprehensible conduct.

JUDGMENT

IT IS, THEREFORE, ORDERED AND ADJUGED that:

1. Defendant Grant Thornton LLP pay William and Martha Yung **$4,682,786** in compensatory damages and **$55,000,000** in punitive damages;

2. Defendant Grant Thornton LLP pay the 1994 William J. Yung Family Trust **$14,632,441** in compensatory damages and **$25,000,000** in punitive damages;

3. Defendant Grant Thornton LLP pay William and Martha Yung pre-judgment interest on **$900,000** from June 11, 2007, through today's date at a per diem rate of 12%.

4. Various motions for sanctions which the court has taken under submission, as well as other issues, remain outstanding; the court is entering an order of even date with this judgment setting a hearing on those matters. Until such time as all remaining issues have been addressed by the court, this is **NOT A FINAL AND APPEALABLE ORDER.**

SO ORDERED this the 8th day of November 2013.

PATRICIA M. SUMME, JUDGE
KENTON CIRCUIT COURT
FOURTH DIVISION

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