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UNITED STATES DISTRICT COURT

FOR THE CENTRAL DISTRICT OF CALIFORNIA

UNITED STATES OF AMERICA, Plaintiff, v. SAMUEL J. DeANGELO; JOE GORDON SHIELDS, a/k/a GORDON SHIELDS; ALAN M. HOVEY; JEFFREY R. WRIGHT; KELLY DAVID, a/k/a DAVID KELLY; and WESTERN TAX SERVICES, INC., Defendants.	NO. SA CV 03-0251 GLT MLGX UNITED STATES' MEMORANDUM IN SUPPORT OF *EX PARTE* APPLICATION FOR TEMPORARY RESTRAINING ORDER AND FOR ORDER TO SHOW CAUSE WHY DEFENDANTS SHOULD NOT BE PRELIMINARILY ENJOINED FROM PREPARING INCOME TAX RETURNS

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Issue Presented

Internal Revenue Code Section 7407 authorizes injunctions against tax return preparers who violate the tax code,

misrepresent their qualifications, or engage in other fraudulent or deceptive conduct. The defendants have systematically prepared thousands of returns claiming bogus deductions to create undeserved refunds. The estimated tax loss from this scheme for the 2000-02 tax seasons alone is $31.5 million. The 2003 tax season is well underway. Should the defendants be enjoined before they prepare more fraudulent returns?

Statement of Facts

The relevant facts are set forth in the Declaration of David A. Gordon, Revenue Agent filed herewith. The Gordon Declaration is incorporated herein by reference.

Argument

The Defendants Should Be Enjoined Immediately Under I.R.C. § 7407 Before They Prepare Any More Fraudulent Returns.

1. Legal standards for TRO and preliminary injunction.

A. Temporary restraining order under Fed. R. Civ. P. 65(b).

Rule 65(b) of the Federal Rules of Civil Procedure provides in relevant part:

> A temporary restraining order may be granted without written or oral notice to the adverse party or that party's attorney only if (1) it clearly appears from specific facts shown by affidavit or by the verified complaint that immediate and irreparable injury, loss, or damage will result to the applicant before the adverse party or that party's attorney can be heard in opposition, and (2) the applicant's attorney certifies to the court in writing the efforts, if any, which have been made to give the notice and the reasons supporting the claim that notice should not be required.

Fed. R. Civ. P. 65(b).

The Gordon Declaration meets Rule 65(b)'s requirement to

prove "specific facts" showing that "immediate and irreparable injury, loss, or damage will result" to the United States if a temporary restraining order is not issued.[1] As discussed below, the injunction sought in this case is authorized by Internal Revenue Code Section 7407, and irreparable injury is presumed from proof of violation of the statute.[2] The Gordon Declaration supplies such proof. Further, the Gordon Declaration demonstrates that the threat of irreparable injury is immediate if the requested TRO is not issued: the defendants operate a high-volume business, this is the busiest time of the year for tax return preparation, and the IRS lacks the resources to audit every return the defendants prepare and collect every dollar of additional tax resulting from such audits. See Gordon Declaration, ¶¶ 117-32.

B. *Preliminary injunction under I.R.C. Section 7407.*

This case is governed by Internal Revenue Code Section 7407. Thus the government need not satisfy the traditional equitable requirements for a preliminary injunction. See United States v.

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[1] The court in United States v. Venie, 691 F. Supp. 834 (M.D. Pa. 1988) issued a TRO prohibiting the defendant from preparing any further tax returns. The defendant was preparing refund returns by consistently claiming head of household status for his customers, regardless of whether the customers were entitled to that status under law, and by overstating their child care expenses.

[2] United States v. Odessa Union Warehouse Co-op, 833 F.2d 172, 175 (9th Cir. 1987) ("Where an injunction is authorized by statute, and the statutory conditions are satisfied as in the facts presented here, the agency to whom the enforcement of the right has been entrusted is not required to show irreparable injury").

Estate Preservation Services, Inc., 202 F.3d 1093, 1098 (9th Cir. 2000) (in an action for a statutory injunction under Section 7408 to enjoin a promoter of an abusive tax shelter, meeting the traditional equitable requirements was not necessary so long as the statutory requirements were satisfied).[3]

Section 7407 authorizes a court to enjoin a person from acting as a return-preparer if that person has continually or repeatedly: (1) violated Code Section 6694, which prohibits the preparation or submission of a return containing an understatement of tax due to unrealistic position or willful or reckless conduct, or Section 6695, which mandates that return preparers include their identifying number on each return they prepare, or any criminal statute; (2) misrepresented his eligibility to practice before the IRS, or otherwise misrepresented his experience or education as a return preparer; or (3) engaged in any other fraudulent or deceptive conduct substantially interfering with the proper administration of the tax laws. In addition, Section 7407 provides that the court must find that a narrower injunction prohibiting only specific misconduct would be insufficient to prevent further

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[3] In non-statutory injunction cases, "the moving party must show either (1) a combination of probable success on the merits and the possibility of irreparable injury or (2) that serious questions are raised and the balance of hardships tips in its favor." Oakland Tribune, Inc. v. Chronicle Publishing Co., 762 F.2d 1374, 1376 (9th Cir. 1985). "These two formulations represent two points on a sliding scale in which the required decree of irreparable harm increases as the probability of success decreases." Id.

interference.[4]

2. The elements of Section 7407 are satisfied.

A. The defendants are "income tax return preparers."

Each of the defendants is an "income tax return preparer"

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[4] Sec. 7407. Action to enjoin income tax return preparers.

(a) Authority to seek injunction.--A civil action in the name of the United States to enjoin any person who is an income tax return preparer from further engaging in any conduct described in subsection (b) or from further action as an income tax return preparer may be commenced at the request of the Secretary. Any action under this section shall be brought in the District Court of the United States for the district in which the income tax preparer resides or has his principal place of business or in which the taxpayer with respect to whose income tax return the action is brought resides. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such income tax preparer or any taxpayer.

(b) Adjudication and decrees.-In any action under subsection (a), if the court finds--

(1) that an income tax return preparer has--

(A) engaged in any conduct subject to penalty under section 6694 or 6695, or subject to any criminal penalty provided by this title,

(B) misrepresented his eligibility to practice before the Internal Revenue Service, or otherwise misrepresented his experience or education as an income tax return preparer,

(C) guaranteed the payment of any tax refund or the allowance of any tax credit, or

(D) engaged in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws, and

(2) that injunctive relief is appropriate to prevent the recurrence of such conduct,

the court may enjoin such person from further engaging in such conduct. If the court finds that an income tax return preparer has continually or repeatedly engaged in any conduct described in subparagraphs (A) through (D) of this subsection and that an injunction prohibiting such conduct would not be sufficient to prevent such person's interference with the proper administration of this title, the court may enjoin such person from acting as an income tax return preparer.

26 U.S.C. § 7407.

within the meaning of Code Section 7701(a)(36). Under Section 7701(a)(36)(A), "income tax return preparer" is defined to mean "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by subtitle A [income taxes] or any claim for refund of tax imposed by subtitle A." The Gordon Declaration, ¶¶ 17-24, shows that the defendants have prepared and continue to prepare tax returns for compensation at offices in Orange County, California. WTS is owned and operated by DeAngelo, who has been in the business of preparing income tax returns for compensation for approximately 30 years. Gordon Declaration, ¶ 17. WTS does business at 5757 E. La Palma Avenue in Anaheim. Gordon Declaration, ¶ 9. WTS employs Wright, David and Hovey as return preparers. Gordon Declaration, ¶ 21. Shields formerly worked as a WTS preparer but now works as a preparer with Tax Matters, Inc., at 12155 Magnolia Avenue, #6G, in Riverside.

B. The defendants have violated Sections 6694 or 6695 of the Code, or have engaged in conduct subject to criminal penalty.

(1) Section 6694.

Section 6694 provides for civil penalties against tax return preparers who prepare tax returns containing understatements of tax liability based on either an unrealistic position, Section 6694(a), or willful or reckless conduct, Section 6694(b).

As shown by the Gordon Declaration, the defendants have systematically prepared and submitted returns containing understatements of tax due within the meaning of Section 6694.

The Gordon Declaration shows that over 90 percent of the returns audited to date show understatements of tax.[5] Gordon Declaration, ¶¶ 3-4. The average understatement of tax on returns prepared by the defendants is $1,919. Gordon Declaration, ¶ 4.

These understatements have been due in most cases to false or inflated deductions claimed for charitable contributions and employee "business expenses," including depreciation. See Gordon Declaration, ¶ 4.

(A) False and inflated charitable contributions.[6]

The defendants did not ask their customers how much they contributed to charity, and generally disregarded what the customers told them about the amount of their contributions. See generally the declarations of individual customers attached as Exhibits to the Gordon Declaration.[7] The defendants did not ask

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[5] In Section 6694(e), "understatement of liability" is defined to mean any understatement of the tax due or any overstatement of the credit or refund due.

[6] A "charitable contribution" is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value. Treas. Pub. 17, Tax Guide 2002, page 164 (excerpts from Pub. 17 are attached hereto as **Exhibit A** for convenience of reference). A gift of property to a qualified organization (for example, a church or other religious organization, Goodwill, Salvation Army) generally can be deducted at the fair market value at the time of the contribution. Id. at page 165.

[7] Maria Flint told Hovey she had $250 in charitable deductions, yet he inserted $4,680 on her return. See Gordon Declaration **Exhibit 14**. Leah Spann told DeAngelo that she had charitable contributions of less than $500, yet he inserted $2,600 on her return. Id., **Exhibit 15**.

if the customers had proper substantiation.[8] They usually just asked a few standard yes-or-no questions such as "do you go to church?" They did not ask the customers questions calculated to determine the correct deductible amounts of their contributions. They generally inserted a false and inflated total amount on the returns.[9] That amount was, in most cases, determined simply by what was necessary to generate a refund.

(B) False or inflated employee "business expenses," including depreciation.[10]

As with charitable contributions, the defendants generally did not ask the customers to provide them with verifiable amounts spent on home computers or home office equipment. They did not ask for substantiation for the amounts spent or the dates when

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[8] Contributions over $250 must be substantiated by an acknowledgment from the recipient qualified organization. Treas. Pub. 17, page 170. The acknowledgment must be in writing and generally must be received by the taxpayer before the return is filed. Id.

[9] Of the 10 returns described in the 10 declarations of former customers attached as Exhibits to the Gordon Declaration, 9 contained false and inflated charitable contributions. The one exception was the return for Eva C. Marez, whose actual contributions of $6,700 were high enough so that the preparer did not need to inflate them to obtain a refund in the amount of $5,362. See **Exhibit 13**, Gordon Declaration.

[10] Unreimbursed employee expenses must equal or exceed 2 percent of adjusted gross income in order to be deductible. See Pub. 17, page 201. Further, such expenses, to be deductible, must be (1) paid or incurred during the tax year, (2) for carrying on the trade or business of being an employee, and (3) ordinary and necessary. Id. Depreciation on computers is allowed only if the computer's use is (1) for the convenience of the employer and (2) required as a condition of employment. Id. Home office expenses may be claimed only if that part of the home is used (1) regularly and exclusively for business and (2) for the convenience of the employer--not if merely appropriate or helpful in the taxpayer's job. Id. at page 202.

the items were purchased or placed in service. They simply asked the customers questions to determine whether they had such items in their homes (or military barracks) and whether the customers used them for business purposes during the tax year. They did not ask the customers questions calculated to determine the correct deductible amounts, such as whether they were purchased as a condition of employment. They generally inserted a false and inflated total amount on Schedule A of the returns. That amount was, in most cases, determined simply by what was necessary to generate a refund.[11]

These false and inflated deductions for charitable contributions and business expenses were due to willful or reckless conduct under Section 6694(b). They resulted from willful attempts to understate the customers' tax liability, Section 6694(b)(1), or from reckless or intentional disregard of the rules and regulations, Section 6694(b)(2). The errors were nearly always on the high side; the preparers rarely if ever understated the allowable deductions.

At the very least, these false and inflated deductions were due to unrealistic positions under Section 6694(a). They did not have a realistic possibility of being sustained on their merits, Section 6694(a)(1), the defendants knew or should of known of

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[11] For example, when preparing a 2000 Form 1040 for customer Michele Gonzalez, a meat clerk at a grocery store, defendant Hovey claimed false employee business expenses of $10,927--nearly 40 percent of her taxable wages of $27,393. See Gordon Declaration, **Exhibit 5**. These expenses, along with $2,600 in false charitable contributions, generated an improper refund of $1,953. See id.

this, Section 6694(a)(2), and they failed to disclose the relevant facts on the returns, Section 6694(a)(3).

In sum, the Gordon Declaration contains evidence clearly establishing that the defendants have violated Section 6694 of the Code.

(2) Section 6695.

Section 6695(c) provides in relevant part that "[a]ny person who is an income tax return preparer with respect to any return or claim for refund and who fails to comply with section 6109(a)(4) with respect to such return or claim shall pay a penalty of $50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect." Section 6109(a)(4) provides in relevant part that "[a]ny return or claim for refund prepared by an income tax return preparer shall bear such identifying number for securing proper identification of such preparer, his employer, or both, as may be prescribed." The regulations promulgated under Section 6109(a)(4) require that where, as here, individual preparers were employed by a corporate preparer, i.e., WTS, the corporate preparer's identification number must be included on the return along with the individual's identification number. Treas. Reg. § 1.6109-2.

The Gordon Declaration, paragraph 7, shows that the defendants have violated Section 6695(c) by consistently failing to furnish the correct identifying number for WTS on the returns they prepared while in the employment of WTS.

(3) Criminal law.

Inserting fictitious deductions on a customer's return is conduct subject to criminal as well as civil penalty. See, e.g., United States v. Kellogg, 955 F.2d 1244 (9th Cir. 1992) (sustaining conviction under I.R.C. § 7206(2) of return preparer who claimed "excessive or wholly fictitious deductions for charitable contributions, dependents, interest payments, business expenses, tax return preparation fees, and the like."). This serves as an additional ground for injunctive relief under Section 7407(b)(1)(A).

C. Shields has misrepresented his eligibility to practice before the IRS.

As shown by paragraph 24 of the Gordon Declaration, Shields' status as an enrolled agent eligible to practice before the IRS was terminated in 1993. Yet Shields continues to use the "E.A." designation when preparing returns. See Gordon Declaration, ¶ 24. Therefore, Shields is misrepresenting his eligibility to practice before the IRS in violation of Section 6695.

D. Injunctive relief is appropriate to prevent the recurrence of prohibited conduct.

Factors that the Court may consider in determining the likelihood of future violations of Sections 6694 and 6695 or criminal law, and thus the need for an injunction under Section 7407(b)(2), include:

> (1) the gravity of the harm caused by the offense; (2) the extent of the defendant's participation; (3) the defendant's degree of scienter; (4) the isolated or recurrent nature of the infraction; (5) the defendant's recognition (or non-recognition) of his own culpability; and (6) the likelihood that defendant's occupation would place

him in a position where future violations could be anticipated.

United States v. Estate Preservation Services, Inc., 202 F.3d 1093, 1098 (9th Cir. 2000).[12]

These factors are satisfied here. First, the harm caused is grave. The IRS estimates a tax loss of $31.5 million for tax years 2000, 2001 and 2002. Second, the extent of the defendants' participation is broad. They prepared an estimated 18,240 returns during the 2000-02 return seasons. Third, scienter may be presumed from the consistent results obtained from audits conducted to date. It is perhaps most obvious in the number of egregious cases involving enlisted Marine Corps personnel, which prompted the VITA officers at Camp Pendleton and Miramar to warn of the scheme and to help at least 22 Marine customers to file correct amended returns. See Gordon Declaration, **Exhibits 18-21**. Fourth, the conduct was recurrent. Fifth, the defendants are not expected to concede any culpability on their part. Sixth, given that all of the defendants remain in business and presumably are continuing to collect unreasonably large fees, future violations are anticipated.

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[12] Section 7408 of the Code provides for an injunction against a person engaging in conduct prohibited by Section 6700 (promoting abusive tax shelters) or Section 6701 (aiding and abetting understatement of tax liability) if the court finds that (1) the person has engaged in any conduct subject to penalty under Sections 6700 or 6701 and (2) injunctive relief is appropriate to prevent recurrence of such conduct.

E. *The defendants should be enjoined from preparing returns, not just from engaging in prohibited conduct, because they have continually or repeatedly engaged in prohibited conduct and an injunction prohibiting such conduct would not be sufficient to prevent their interference with the proper administration of the Internal Revenue laws.*

That the defendants have continually and repeatedly engaged in prohibited conduct should be without dispute. The Gordon Declaration incorporates as exhibits ten separate declarations from ten former customers. Each declaration contains evidence in the form of testimony from an individual customer of at least one violation of Section 6694 and/or criminal law. The spreadsheets attached to the Gordon Declaration as Exhibits 1, 2 and 21 summarize the statistical evidence. There has been a clear pattern of abuse over several years.

More to the point, the threat of harm is continuing. An injunction limited to prohibiting the defendants from engaging in prohibited conduct would be insufficient to prevent their continued interference with the proper administration of the federal tax laws. An injunction to stop them from preparing any further returns is necessary.

The defendants have a powerful financial incentive for continuing to do business improperly. Through their reputation for obtaining refunds, and through their policy of allowing customers to defer payment until they receive their refunds, the defendants have been able to charge fees well in excess of what is reasonable. Gordon Declaration, ¶ 119.

WTS's records show that it grossed the following fees for

return preparation for the relevant tax seasons:

Tax Season	Tax Year	Revenue Earned by DTS/WTS
2001	2000	$6.1 million (Jan. 2001-Jun. 2001)
2000	1999	$2.8 million
1999	1998	$1.3 million

Gordon Declaration, ¶ 120.

During the current tax season, WTS has sent out a letter to customers boasting of its "aggressive nature" in claiming deductions. Gordon Declaration, ¶ 121. A true copy of this letter, dated January 15, 2003, is attached as **Exhibit 22** to the Gordon Declaration. The letter emphasizes that, "as always," WTS stands ready to help customers claim "every possible deduction." Id. But only two deductions are mentioned by name--charitable contributions and business expenses (italics added):

> We at Western Tax Service, as always are here to help you with *every possible deduction* that you are legally entitled to and because of this *aggressive nature* we need to make sure that we fully document all of your deductions. This includes *contributions, business expenses,* etc.

WTS has sent out another letter, dated January 1, 2003, containing instructions to customers who have been selected for an IRS audit. Gordon Declaration, ¶ 122. A true copy of that letter is attached to the Gordon Declaration as **Exhibit 23**.

The January 1, 2003 letter advises customers about defending their charitable contributions and employee "business expenses." Gordon Declaration, ¶ 123. Specifically, the January 1, 2003

letter provides detailed guidelines for creating receipts and other documentation after the fact to support the deductions for charitable contributions and employee business expenses taken on returns prepared by WTS. Id. at ¶ 124.

To the extent the January 1, 2003 letter suggests that creating such receipts and other documentation is acceptable way of substantiating deductions on prior returns, it is improper. Gordon Declaration, ¶ 125. The necessary substantiation to support a deduction generally should exist at the time the return is prepared. Id.

For example, to substantiate a deduction on a prior year's return for automobile expenses, it is not proper to "recreate a mileage log" as advised in the January 1, 2003 letter. Gordon Declaration, ¶ 126. Regularly kept contemporaneous records are generally necessary for that purpose. Id.

The January 1, 2003 letter is misleading in other respects. Gordon Declaration, ¶ 127. Using a table listing numerous examples, it indicates that deductions for in-kind charitable contributions (for example, contributions of clothing or household items to Goodwill) may be taken at original cost rather than at fair market value at the time of contribution:

Item	Cost
12 boxes of clothing	3,600
1 couch	825
1 mountain bike	300
1 Maytag washer & dryer	1,050
1 bedroom set	2,000

4 lamps	400
1 32" Hitachi television	675
1 Sony stereo system	500
7 suits	2,400
25 pairs of shoes	650
1 dishware set	425
	Total

See id., **Exhibit 23**. Using acquisition cost rather than fair market value at time of contribution would nearly always significantly overstate the allowable amount of the deduction. Gordon Declaration, ¶ 127.

Further, the January 1, 2003 letter represents that customers can validly create and sign their own receipts for charitable contributions in excess of $250, providing suggested language ("I, John Doe, gave Calvary Chapel of Costa Mesa $2,500.00 for the 2000 year"). Gordon Declaration, ¶ 128; see **Exhibit 23** thereto. This is incorrect advice. Gordon Declaration, ¶ 128. Contributions of $250 or more are deductible only if substantiated by an acknowledgment of the contributions from the qualified organization or certain payroll deduction records. Id.

The January 1, 2003 letter also implies that computers and other home office equipment can be depreciated and deducted as miscellaneous Schedule A "business expenses" if the customer uses them even occasionally for business purposes ("Depreciation relates to an item that you either purchased or placed in service

that year which you use for business purposes such as a computer or office equipment"). Gordon Declaration, ¶ 129; see **Exhibit 23** thereto. That is not the law. Gordon Declaration, ¶ 129. Such items are deductible only if their use is for the convenience of the employer and required as a condition of employment. Id. Home office deductions are subject to additional requirements. See note 9 above.

If the defendants are not enjoined from preparing income tax returns, it is Revenue Agent Gordon's opinion, based on the facts set forth in his declaration, that the defendants will continue to prepare false and fraudulent tax returns, understating their customers' tax liability through the use of bogus deductions for charitable contributions and miscellaneous "business expenses." Gordon Declaration, ¶ 130. (The defendants may also be engaging in other abusive schemes as well; with respect to the 1999 tax year, DeAngelo claimed a bogus "slave reparation credit" of $40,000 on behalf of an African-American customer.) Id.

Allowing the defendants to continue doing business as they have in the past will result in a continuing and severe loss of tax revenue. Gordon Declaration, ¶ 131. It will result in a continuing strain on IRS resources, because the IRS cannot audit every return the defendants prepare. Id. And it will cause financial hardship to customers who will be audited--many will be required to pay unexpected tax liabilities, including interest accruing from the due date of the return to the date of payment, and perhaps penalties. Id.

In sum, allowing the defendants to continue doing business as usual will cause further substantial interference with the proper administration of the internal revenue laws.

Conclusion

As discussed above, the Court is requested to enter (i) a temporary restraining order enjoining the defendants, and all persons in active concert with them, from preparing federal income tax returns and (ii) an order to show cause why a preliminary injunction should not issue, after the TRO expires, to continue enjoining the defendants, and all persons in active concert with them, from return preparation pending a trial on the merits of the complaint for permanent injunctive relief. A proposed temporary restraining order and show-cause order is filed herewith.

Respectfully submitted,

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