

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

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RONALD W. MITCH, SR., CLERK
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UNITED STATES OF AMERICA,

Plaintiff,

1:07 CV0042

-vs.-

Case No. _____

DONALD A. GRAY,

COMPLAINT FOR PERMANENT
INJUNCTION AND OTHER
EQUITABLE RELIEF

Defendant.

Wendell A. Miles
Senior, U.S. District Judge

_____/

Plaintiff, the United States of America, complains and alleges against the
defendant, Donald A. Gray, as follows:

Nature of Action

1. This is a civil action brought by the United States pursuant to Sections 7402(a), 7407, and 7408 of the Internal Revenue Code (26 U.S.C.) ("I.R.C.") to restrain and enjoin Gray and anyone in active concert or participation with him from preparing or filing federal tax returns or forms for others, and from engaging in any activity subject to penalty under 26 U.S.C. § 6694, 6695, or 6701, and from engaging in any other conduct that interferes with the administration and enforcement of the internal revenue laws.

Jurisdiction and Venue

2. This civil action has been requested by the Chief Counsel of the Internal Revenue Service, a delegate of the Secretary of the Treasury, and commenced at the direction of a delegate of the Attorney General of the United States.

3. Jurisdiction is conferred on this Court by 28 U.S.C. §§ 1340 and 1345, and by IRC (26 U.S.C.) §§ 7402(a), 7407, and 7408.

4. Venue is proper pursuant to 28 U.S.C. § 1391 because Gray resides within this judicial district.

Defendant

5. Gray resides in Portage, Michigan. Gray does business through his sole-proprietorship and receives referrals through the Internet at the website www.losthorizons.com.

Gray's Activities

6. Since 2004, Gray has been preparing false federal income tax returns and related forms for customers to fraudulently under-report their income. On the returns he prepares for customers Gray falsely states that he is a licensed CPA.

7. Gray brags on the www.losthorizons.com website that he holds an MBA degree, falsely claims he is a licensed CPA, and offers to prepare income tax returns for customers using the fraudulent methods promoted by Peter Eric Hendrickson of Commerce Township, Michigan, on the losthorizons website and in Hendrickson's publication *Cracking the Code*. The United States has sued Hendrickson and others in connection with that fraudulent scheme. The complaints in those cases are posted at <http://www.usdoj.gov/tax/txdv06219.htm>. A number of the defendants in those case have been ordered to return tax refunds erroneously made to them, and have done so. The

other cases are pending. An Arizona return preparer, Jeffrey R. Hunn, has been permanently barred from preparing tax returns based on his implementation of the Hendrickson tax-fraud scheme. <http://www.usdoj.gov/tax/txdv06567.htm>.

8. On the returns he prepares, Gray either falsely reports that his customer received no income or Gray substantially under-reports his customer's income, and fraudulently claims a refund of all federal taxes withheld from his customer's wages.

9. Gray attaches to the returns he prepares IRS Forms 4852 (Substitute for Form W-2, Wage and Tax Statement) and/or IRS Forms 1099-MISC (Miscellaneous Income) in lieu of the correct W-2 forms that his customers received from their employers.

10. On the Forms 4852, which Gray prepares for his customers, he falsely and fraudulently states that his customer received no wages, while at the same time reporting the amount of federal income tax, Social Security tax, and Medicare tax withheld from the customer's wages.

11. Where the Form 4852 asks what efforts were made to obtain a correct Form W-2 or 1099, Gray falsely and fraudulently responds with statements, including:

- "Company fears retaliation from IRS. These are not 'wages. . .'"
- "Corrected Form 1099 Submitted to rebut a document known to have been submitted by . . . 'payer' which erroneously alleges payment of 'gains, profits, or income.'"

12. On the Forms 1099-MISC Gray prepares and submits with returns he prepares

for customers, he falsely reports that his customer received no income by entering “0” in box 7, which calls for the amount of non-employee compensation. He falsely checks the box on these forms stating that the form is “corrected.”

13. On many of these so-called “corrected” Forms 1099, Gray inserts the following oath:

This corrected Form 1099-MISC is submitted to rebut a document known to have been submitted by the party identified above as ‘PAYER’ which erroneously alleges a payment to the party identified above as the ‘RECIPIENT’ of “gains, profit or income” made in the course of a “trade or business”. Under penalty of perjury, I declare that I have examined this statement and to the best of my knowledge and belief, it is true, correct, and complete.

14. Gray includes an “Affidavit of Service” with many of the returns he prepares which acknowledges mailing of the Forms 1040, and the so-called “corrected” Forms 4852, and 1099.

15. Gray reports on his customers’ returns as “federal income tax withheld” the Social Security and Medicare taxes withheld from his customers’ wages. Social Security and Medicare taxes are distinct from income taxes and should not be reported on federal income tax returns.

16. For those customers who have already filed tax returns correctly reporting their taxable income, Gray prepares false and fraudulent amended returns (Forms 1040X) that report zero income. The amended returns request a refund of all income taxes withheld (and include Social Security and Medicare taxes in the income tax figure). On

the line asking for an “Explanation of Changes to Income,” Gray reiterates the same false claims that wages are not income and attaches the same false “corrected” Forms 1099 and 4852 as described above.

17. On the amended returns (Forms 1040X) and Forms 4852 he prepares, Gray cites I.R.C. §§ 3121 and 3401, both of which define the term “wages.”

18. Gray’s citation of I.R.C. §§ 3121 and 3401, his use of Forms 4852 and so-called “corrected” Forms 1099, the alterations he makes to those forms, and his mischaracterization of Social Security and Medicare taxes as income taxes, all follow the scheme promoted by Peter Hendrickson. Hendrickson falsely claims that under I.R.C. §§ 3121 and 3401, only income received from the federal government is subject to federal tax. Federal courts have uniformly and repeatedly rejected this argument. *See, e.g., United States v. Latham*, 754 F.2d 747, 750 (7th Cir. 1985) (characterizing the argument “that under 26 U.S.C. § 3401(c) the category of ‘employee’ does not include privately employed wage earners [as] a preposterous reading of the statute.”); *Abdo v. United States*, 234 F. Supp. 2d 553, 563 (M.D.N.C. 2002) (noting at the claim that wages are not income “has been rejected as many times as it has been asserted.”), *aff’d* 63 Fed. Appx. 163 (4th Cir. 2003). 19. IRS records reflect that Gray has not filed a valid federal income return for himself since 1999. For the 2002 tax year, Gray filed the same fraudulent “zero return” he prepares for customers on November 26, 2005. Gray’s return, like those he prepares for customers, attached false Forms K-1 and 1099 reporting no

taxable income.

20. Gray's claims that he earned no income in 2002 is false. Gray's assertion on his return that he received "zero" income is based on the same false theory that wages are not income.

21. The IRS notified Gray on August 17, 2006 that it was investigating his return-preparation business for possible violations of internal revenue laws.

22. At the same time, the IRS issued an Information Document Request to Gray requesting copies of all the federal returns he has prepared on behalf of others, a list of all persons for whom he had prepared returns, and other information. The IRS also asked Gray to meet with an IRS employee to answer questions concerning his return preparation and to provide a list of his customers.

23. In response, Gray mailed a letter to the IRS acknowledging that he had been preparing returns that the IRS "considers frivolous or abusive" for the past year. He refused to provide copies of the returns he prepared for customers.

**Gray's Fraudulent Return Preparation
Has Caused an Estimated \$1.5 Million in Tax Losses So Far**

24. Gray has customers in several states for whom he has prepared fraudulent returns as described above, including California, Florida, Georgia, Hawaii, Michigan, North Carolina and Texas.

25. Thus far, the IRS has examined a total of fifty returns prepared by Gray with the fraudulent characteristics described above, which falsely claimed refunds totaling

\$188,587.

26. From its audits of some Gray-prepared returns, the IRS estimates that Gray under-reports his customers' tax liabilities by an average of \$4,385 per return.

27. Based on the IRS's estimates, the United States calculates that Gray's fraudulent return preparation has resulted in approximately \$1.5 million in harm and potential harm to the United States. This total does not include the additional amounts the IRS must expend in identifying and recovering the lost revenue Gray has caused, and in investigating and bringing this suit.

Count I: Injunction under IRC § 7407

28. The United States incorporates by reference the allegations in paragraphs 1 through 27.

29. I.R.C. § 7407 authorizes a district court to enjoin an income tax return preparer from:

- (A) engaging in conduct subject to penalty under I.R.C. §§ 6694 or 6695;
- (B) misrepresenting his experience or education as an income-tax preparer;
- (C) guaranteeing the payment of a tax refund or the allowance of a tax credit; or
- (D) engaging in any fraudulent or deceptive conduct that substantially interferes with the proper administration of the internal revenue laws,

if the court finds that injunctive relief is appropriate to prevent recurrence of such

conduct.

30. If a court finds that the preparer's misconduct is continual or repeated, and that a narrower injunction prohibiting only the specific conduct would not be sufficient to prevent his interference with the proper administration of the internal revenue laws, I.R.C. § 7407 authorizes the court to enjoin him from preparing returns altogether.

31. I.R.C. § 6694(a) penalizes a return preparer who understates a customer's liability based on a position for which there was no realistic possibility of being sustained on the merits, if the return preparer knew or reasonably should have known of the unrealistic position and the unrealistic position was frivolous.

32. I.R.C. § 6694(b) penalizes a return preparer who understates a taxpayer's liability due to willfulness, recklessness, or an intentional disregard of rules and regulations.

33. I.R.C. § 6695(b) penalizes a return preparer who fails to sign the income tax returns he prepares.

34. I.R.C. § 6695(d) penalizes a return preparer who fails to retain a copy of the returns he prepares or a list of the names and taxpayer identification numbers of those for whom he prepares returns, and to make the copies or list available to the IRS on request as required by I.R.C. § 6107(b).

35. Gray has engaged in conduct subject to penalty under I.R.C. § 6694 by preparing returns that understate his customers' liabilities based on frivolous positions for

which there is no realistic possibility of being sustained on the merits. Specifically, his returns contain the following frivolous positions:

- that his customers either had no income or had substantially less income than they actually did;
- that his customers' wages are not taxable income;
- that the Social Security and Medicare taxes withheld from his customers' wages were federal income taxes; and

36. Gray knew of the frivolous and unrealistic positions taken in the returns he prepared and filed for customers.

37. The unrealistic positions Gray took were frivolous and without a reasonable basis.

38. Gray violates I.R.C. § 6694(b) because his understatements of his customers' liabilities are due to either willfulness, recklessness, or an intentional disregard of rules and regulations.

39. Gray has engaged in conduct subject to penalty under I.R.C. § 6695(b) by failing to sign the returns he prepares.

40. Gray has engaged in conduct subject to penalty under I.R.C. § 6695(d) by refusing to comply with the IRS's request for either copies of the returns he prepared or a list of the customers for whom he prepared returns.

41. Gray's false claims that he is a licensed CPA are conduct subject to injunction

under I.R.C. § 7407(b)(1)(B), since he misrepresents his qualifications as a return preparer.

42. Gray engages in fraudulent and deceptive conduct substantially interfering with the proper administration of the internal revenue laws by:

- falsely reporting that his customers received either no income or substantially less income than they did;
- excluding his customers' wages from the income he reports on their returns;
- including Social Security and Medicare taxes as federal income taxes withheld;
- claiming refunds for his customers to which they are not entitled;
- purporting to "rebut" properly filed Forms W-2 and 1099 with his fraudulent Forms 4852 and 1099-MISC;
- inserting a fraudulent oath on Forms 1099-MISC;

43. Gray's continual and repeated violations of I.R.C. §§ 6694 and 6695, his misrepresentation that he is a licensed CPA, and his fraudulent and deceptive conduct fall within I.R.C. § 7407(b)(1)(A), (B), and (D), and thus are subject to injunction under I.R.C. § 7407.

44. Gray is likely to continue to prepare fraudulent federal tax returns unless he is enjoined.

45. Gray's continual and repetitious conduct subject to injunction under I.R.C.

§ 7407, and his refusal to cooperate with the IRS's investigation demonstrate that a narrow injunction prohibiting only specific misconduct would not prevent his continued interference with the proper administration of the internal revenue laws. An injunction permanently barring him from acting as a return preparer is warranted.

Count II: Injunction under I.R.C. § 7408

46. The United States incorporates by reference the allegations in paragraphs 1 through 45.

47. I.R.C. § 7408 authorizes a district court to enjoin any person from engaging in conduct subject to penalty under either I.R.C. § 6700 or § 6701 if injunctive relief is appropriate to prevent recurrence of that conduct.

48. I.R.C. § 6701 imposes a penalty on any person who aids or assists in, procures, or advises with respect to the preparation or presentation of a federal tax return, refund claim, or other document knowing (or having a reason to believe) that it will be used in connection with any material matter arising under the internal revenue laws and knowing that if it is so used it would result in an understatement of another person's tax liability.

49. Gray's preparation of false Forms 1040, 1099, and 4582 claiming that wages are not income is conduct subject to penalty under I.R.C. § 6701.

50. Unless enjoined by this Court, Gray is likely to continue to engage in such conduct.

51. Injunctive relief is therefore appropriate under I.R.C. § 7408.

Count III:
Injunction under I.R.C. § 7402(a)
for Unlawful Interference with Enforcement of the
Internal Revenue Laws and the Appropriateness of Injunctive Relief

52. The United States incorporates by reference the allegations in paragraphs 1 through 51.

53. I.R.C. § 7402(a) authorizes a court to issue injunctions as may be necessary or appropriate for the enforcement of the internal revenue laws, even if the United States has other remedies available for enforcing the internal revenue laws.

54. Gray, through the actions described in paragraph 42, has interfered with the enforcement of the internal revenue laws.

55. If Gray is not enjoined, he is likely to continue to interfere with the enforcement of the internal revenue laws.

56. The United States is harmed by Gray's tax return preparation service because Gray's customers are not reporting or paying the correct amount of taxes and because they are claiming refunds to which they are not entitled.

57. The United States is also harmed because the IRS is forced to devote its limited resources to identifying and recovering lost revenue from Gray's customers.

58. The United States will suffer irreparable harm if Gray is not enjoined because the tax losses he causes with his fraudulent returns will continue to accumulate and may prove to be unrecoverable, and because the IRS will have to continue to devote resources to assessing and collecting his customers' taxes.

59. While the United States will suffer irreparable harm if Gray is not enjoined, Gray will not be harmed by being compelled to obey the law.

60. The public interest will be advanced by enjoining Gray because an injunction will stop his illegal conduct and the harm that conduct is causing.

61. Gray harms his customers by preparing fraudulent and frivolous returns that lead to additional penalties and interest when the IRS discovers Gray's errors and assesses taxes against the customers.

62. In addition, Gray harms his customers by improperly charging them a contingent fee.

WHEREFORE, plaintiff United States of America respectfully prays for the following:

A. That the Court find that Gray has continually and repeatedly engaged in conduct subject to penalty under I.R.C. §§ 6694, 6695, and 6701 and in fraudulent or deceptive conduct substantially interfering with the proper administration of the internal revenue laws; that he has misrepresented his education as a return preparer; and that injunctive relief under I.R.C. §§ 7407 and 7408 is necessary and appropriate to prevent recurrence of his conduct;

B. That the Court find that Gray has interfered with the enforcement of the internal revenue laws, and that injunctive relief is appropriate to prevent the recurrence of that conduct pursuant to I.R.C. § 7402(a) and the Court's inherent equity powers;

C. That the Court, pursuant to I.R.C. §§ 7402(a) and 7407, enter a permanent injunction prohibiting Gray from preparing or filing, or assisting in the preparation or filing, of federal income tax returns and related documents for any person other than himself;

D. That the Court, pursuant to I.R.C. §§ 7408 and 7402(a), enter a permanent injunction prohibiting Gray, individually and doing business under any other name or using any other entity, and his representatives, agents, servants, employees, attorneys, and those persons in active concert or participation with him, from directly or indirectly:

1. Preparing or assisting in the preparation or filing of documents relating to a matter material to the internal revenue laws, including federal tax returns and related documents, for any person other than himself;
2. Preparing or assisting in the preparation or filing of any documents, including "corrected" Forms 1099, or Forms 4582 for submission to the IRS for any person other than himself;
3. Engaging in any other activity subject to penalty under I.R.C. §§ 6694, 6695, 6701 or any other penalty provision of the Internal Revenue Code; and
4. Engaging in other conduct interfering with the enforcement of the internal revenue laws;

E. That the Court, pursuant to I.R.C. § 7402(a), order Gray to mail, at his expense,

to Peter Hendrickson and to all persons for whom he has prepared returns or any other tax-related document for submission to the IRS, a copy of the permanent injunction and a cover letter drafted by the United States informing his customers of the permanent injunction;

F. That the Court, pursuant to I.R.C. §§ 7402(a), 7407, and 6695, order Gray to produce to counsel for the United States a list identifying by name, taxpayer-identification number, address, e-mail address, and telephone number all persons for whom he has prepared federal tax returns and any other tax-related document for submission to the IRS;

G. That the Court, pursuant to I.R.C. §§ 7402(a), 7407, and 6695, order Gray to produce to counsel for the United States copies of all federal tax returns, including amended returns and other tax forms, and any other documents he has prepared for any person for submission to the IRS from January 1, 2001, to the present;

H. That the Court order Gray to complete the requirements listed in paragraphs E through G within eleven days of the Court's order and order him to file with the Court a certificate of compliance with those requirements, signed under penalty of perjury, along with evidence of compliance, within twelve days of the Court's order;

I. That the Court retain jurisdiction over Gray and this action for the purpose of enforcing any permanent injunction entered against him;

J. That the United States be permitted to conduct post-judgment discovery for the

purpose of monitoring Gray's compliance with the terms of any permanent injunction entered against him; and

K. That the Court grant the United States such other relief, including costs, as is just and equitable.

Dated this 16th day of January, 2007.

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