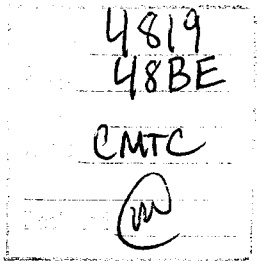
UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

UNITED STATES OF AMERICA,
PLAINTIFF

VS.

ROBERT C. WELTI, INDIVIDUALLY AND D/B/A BOPAT ENTERPRISES,
DEFENDANTS

CASE NO. C-1-02-243
(DLOTT, J.)
(HOGAN, M.J.)



REPORT AND RECOMMENDATION

Before the Court is Plaintiff's Motion for a Preliminary Injunction (Doc. 11) and Plaintiff's Reply (Doc. 18). Defendant, who is proceeding on a pro se basis, although he is a C.P.A. and an experienced accountant, filed no Memorandum in Opposition. An evidentiary hearing on Plaintiff's Motion was conducted on October 19, 2002 and succeeding days. The Government is seeking to prevent Defendant, who conducts his profession in Ripley, Ohio, from the preparation of federal income tax returns that understate taxpayer liability by the use of trusts and from representing clients before the Internal Revenue Service. In addition, the Government seeks and Order requiring Defendant to produce a list of all persons for whom he provided such services. Based upon the evidence, both in the form of witness testimony and exhibits, the Plaintiff's Motion is well-taken and should be granted.

PRELIMINARY INJUNCTION STANDARD

Although the Government argues that because injunctive relief is authorized by statute, 26 U.S.C., Sections 7402, 7407 and 7408, traditional equitable considerations need not be considered, we believe that the safer path is to consider the following factors: (1) substantial likelihood of success on the merits, (2) a substantial threat of irreparable injury if the injunction is not granted, (3) whether the threat of injury to the Government outweighs the harm that injunctive relief would cause Defendant, and (4) the effect that injunctive relief would have on the public's interest. *Marchinski v. Howard*, 2002 FED App. 0367P (6th Cir. 2002).

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Under 26 U.S.C., Section 7402, the Court may issue injunctive relief to enforce the internal revenue laws.

Under 26 U.S.C., Section 7407, a preliminary injunction may be granted if the Government demonstrates that (1) Defendant engaged in conduct subject to penalty under 26 U.S.C., Section 6694 or engaged in any other fraudulent and deceptive act that substantially interferes with the proper administration of the internal revenue laws and (2) injunctive relief is appropriate to prevent a recurrence of such conduct. Title 26 U.S.C. Section 6694 imposes a penalty on a preparer of income tax returns who either knows or reasonably should know that a claim contained an understatement of tax liability due to a frivolous position for which there was no realistic possibility of being sustained.

The Government argues that, in addition, 26 U.S.C., Section 7408 provides a basis for granting injunctive relief. Section 7408 authorizes injunctive relief if the Government demonstrates that Defendant engaged in conduct subject to penalty under 26 U.S.C., Section 6701, which, in turn, imposes penalties upon any person who aids, assists or advises with respect to the preparation of tax returns when Defendant knows or has reason to believe that such advice will be used in connection with any material matter to understate the tax liability of another. The Government argues that the culpable mental state or lack thereof is illustrated by: (1) one's reliance upon knowledgeable professionals, (2) one's level of education and sophistication and (3) one's familiarity with tax matters. See *Estate Preservation Services*, 202 F.3d at 1103.

PRELIMINARY MATTERS

Defendant failed to file any responsive pleading directed to the merits of the Government's Motion. Rather, Defendant challenged the authority of Michael R. Paul, Esq., an attorney not licensed to practice law in Ohio, to prosecute this case. We find 28 U.S.C., Sections 515(a) and 517 to be amply authority for Mr. Paul, a Government lawyer assigned to the Tax Division of the United States Department of Justice, to prosecute the case.

Defendant also challenged the authority of the magistrate judge to hear the case in the absence of consent by the parties. The magistrate judge's authority to hear, consider and report his recommendation to an Article III judge is described at 28 U.S.C., Sections 636(b)(1)(B) and (b)(3) as well as Local Rule 72.1. The Order of reference is listed as Document 3 in the record. Contrary to Defendant's assertion to the contrary, the magistrate judge is "empowered to deal

with all pretrial procedures, whether dispositive or not, and render a report and recommendation to the Court on any matters classified as dispositive by statute." (See Doc. 3)

The Government asserts that the Court could render its Report and Recommendation without an evidentiary hearing and that it should do so in this case since Defendant failed to file a Memorandum in Opposition. See *United States v. Rosile*, 202 WL 1760861 (M.D. Fla. 2002). Because Defendant is pro se and since the remedy sought by the Government is so drastic, this Court chose to proceed cautiously and afford the Defendant the opportunity to confront the witnesses and evidence against him. Defendant offered no factual evidence and the evidence he did offer was in the form of written arguments challenging the I.R.S. to impose any tax on an individual's domestic income and its authority to investigate whether tax returns comply with the law. Considering the fact that Defendant is both a licensed professional and a certified public accountant with a wealth of experience, this Court finds both these arguments to be both alarming and specious. The theory underlying Defendant's position in this case is that one can lawfully create a trust, maintain complete control over all the trust's assets, and pay no income tax. Since the major premise is absurd, what follows is equally absurd whether it be in the form of a business trust, equipment or service trust, family residence trust, charitable trust or final trust.

MUHICH V. COMMISSIONER OF INTERNAL REVENUE

Plaintiff urges us to follow the law as stated by the Seventh Circuit in *Frank Muhich v. Commissioner of Internal Revenue*, 238 F.3d 860 (7th Cir. 2001). The similarity of the Muhich situation will become apparent as we summarize the facts. Muhich was the President of an Illinois company called Midwest Portraits Corporation. Muhich met with an financial planner named Myers, who was a representative of Heritage Assurance Group, a promoter of abusive trust schemes. After meeting Bartoli, a Heritage attorney and subsequently being referred to an accountant named Savino, Muhich paid Heritage $12,000 for an abusive trust packet and thereafter created the Muhich Asset Management Trust. The trust scheme adopted by Muhich was described in the opinion as follows:

> "An individual transfers his or her assets and right to receive income to a newly created family trust in exchange for a certificate of beneficial

> interest (CBI). A CBI gives the individual the right to receive any distributions that the trustee, who is the same as the transferring individual, decides to make. The family trust pays and deducts all of the trustee's personal expenses and distributes any excess corpus to a charitable trust created under the scheme. The individual creates other trusts to circulate funds among and between."

The Muhichs created the Muhich Asset Management trust and transferred all of their property to it, in return for which they received a CBI representing 90 units. The Muhich Asset Management Trust then set up the Muhich Charitable Trust and received 100 units of ownership in the Muhich Charitable Trust. The Muhich Asset Management Trust then created the Muhich Business Trust and received 100 units of ownership. The Muhich Business Trust then created the Muhich Equity Trust and the Muhich Vehicle Trust and funded the corpus of each trust with $10 in exchange for a CBI from each trust representing 100 units of ownership. The Muhichs were the sole trustees and beneficiaries of all 5 trusts and as the opinion stated "had exclusive control over the trust property, had the right to direct any and all distributions from the trusts, controlled the bank accounts and their ability to deal with and benefit from all trust property was as free and unrestricted as before the trusts were established."

The issue before the Circuit was whether, as the Tax Court previously found, the trusts were "shams." In referring to the nondeductibility of personal expenses, the Circuit cited Chirelstein's Federal Income Taxation (2d Ed., 1979) for the principle that "Personal consumption expenses must obviously be treated as nondeductible on the whole; if they were allowed, the individual tax base could be reduced to zero through expenditures on personal living items and the notion of a tax on economic gain would have to be abandoned." The Circuit referred to a "sham" transaction as having no economic effect other than to create tax losses and cited *Gregory v. Helvering*, 293 U.S. 465 (1935) for the principle that "the Commissioner is not required to recognize for tax purposes those transactions which lack economic substance." Despite the fact that the Seventh Circuit's view is not controlling here, its holding is not unique and certainly reflects the prevailing law in this Circuit and in the country.

EVIDENCE AND EXHIBITS

David C. Morgeson, an I.R.S. agent for 19 years, testified that abusive trust arrangements were the subjects of I.R.S. Notice 9724, entitled Certain Trust Arrangements, published in April, 1997 (Exhibit 4). The Notice emphasized the following legal principles upon which the above-mentioned trusts would be evaluated:

(1) The substance rather than the form of the transaction is controlling for tax purposes. If the relationship of the trust property to the grantor did not differ in any material respect after the creation of the trust, then the income and assets would be taxed to the grantor and the trust mechanism ignored.

(2) If the owner of property transferred to a trust retains an economic interest in or control over the property, all expenses and income of the trust are taxable to the owner.

(3) A lawfully created trust is taxed on its income, reduced by amounts distributed to beneficiaries. The trust must obtain a taxpayer identification number and file annual returns reporting its income. The trust must report distributions to beneficiaries on Form K-1 and the beneficiary must report the distributed income on the beneficiary's tax return.

(5) Nondeductible personal expenses cannot be transformed into deductible expenses by the use of trusts and the costs of creating those trusts are not deductible.

(6) A genuine charity, not the owner or the owner's family members, must benefit in order to claim a valid charitable deduction.

(7) A U.S. citizen that fails to report a transfer of property to a foreign trust or the receipt of a distribution from a foreign trust is subject to a tax penalty equal to 35% of the gross value of the transaction.

(8) Civil and/or criminal penalties may apply.

In addition, the Notice encouraged taxpayers who have participated in abusive trust arrangements to voluntarily file amended returns and supplied a phone number for those who had questions regarding the Notice or the information contained therein. Mr. Morgeson testified that Notice 9724 was published on the I.R.S. web site, in the Federal Register, and was available to the general public.

Mr. Morgeson testified that his investigation of Defendant began approximately 2 years

ago and involved the review of 103 tax returns from taxpayers in 20 states. He classified 71 out of 103 returns as "abusive" and distributed all 71 to be audited. Mr. Morgeson personally reviewed 35 of these returns. A number of these returns were closed due to criminal prosecution or successfully resolved by deficiency assessments and voluntary payments by taxpayers. The average understatement of tax liabilities for returns prepared by Defendant and reviewed by Mr. Morgeson was estimated to be $92,172 per return. Mr. Morgeson said that Defendant's filing of abusive returns began in 1999 and continued through 2001. The investigation showed that Defendant obtains clients from Heritage Companies in Illinois and HG Asset Management in Ohio. Both are classified as "abusive trust promoters." At present, I.R.S. has audited 26 returns at an average of 550 hours per taxpayer. I.R.S. has collected $170,000 from three of the audited taxpayers whose "trusts" were admitted to be shams and expects to recover a total of $645,000 from cooperating taxpayers.

Morgeson sent Defendant a letter in November, 2001 and informed him that he was under investigation for possible violations of 26 U.S.C., Section 6701 and requested copies of the trust instruments and a list of Defendant's clients. Defendant was required to attend a meeting in January, 2002, but Defendant both refused to attend the meeting and refused to submit the requested documentation. Defendant's response, also in January, 2001, called to Mr. Morgeson's attention that "Title 26 and Title 27 of the United States Code are not positive law and of limited application to the residents of the fifty states" and challenged Morgeson's "standing" to either investigate or prosecute him. In addition, Defendant threatened to make Morgeson a party (we don't believe he meant a plaintiff) to a class-action law suit.

Lastly, Morgeson noted the similarity in the returns he reviewed. The vehicle of the "business trust" was used to significantly reduce or eliminate self-employment income and tax on Form 1040 by taking large deductions for management or commission fees on Schedule C. The management or commission fees are then paid to another trust under the control of the taxpayer. The vehicle of the "final trust" used a domestic trust to claim an income distribution deduction on Form 1040. The income distribution to an offshore trust offsets the domestic trust's income. The offshore trust then distributes its income to a second offshore trust under the control of the taxpayer and located in Belize. The "charitable trust" uses a charitable deduction to a second charitable trust or foundation controlled by the taxpayer. Lastly, a "family residence trust" is used to put the taxpayer's business in trust and than claim deductions for nondeductible

personal expenses charged to the trust.

As evidence of his claim that Defendant has embarked upon a pattern and practice of obstructing I.R.S. investigations and audits, the Government calls our attention to Exhibits E, F, G, H and I. Exhibit E is a transcript of a meeting between I.R.S. Agents Walsh and Kochert with Defendant in January, 2002 in which the agents were attempting to obtain information from Defendant about the Wellbrooks Asset Management Trust. Instead of providing the books and records as requested, Defendant used the time to put into the record 38 exhibits, none of which aided the agents in conducting an audit. Exhibit F is a copy of a letter Defendant wrote to client Ruth Rutledge and explaining that she need not report her payment to Defendant for income tax services under authority of 26 U.S.C., Section 861. Exhibits G and H are hearsay newspaper accounts of the Government's struggles with Defendant and are given no weight. Exhibit I is a five-page "challenge" to Mr. Morgeson's authority, which is authored by Defendant and given considerable weight by this Court. These exhibits display either a superficial understanding of the law or an irrational belief about what the law requires. Either is particularly troubling when one considers that Defendant is in the business of rendering professional advice about the tax law to consumers seeking his advice and following it. From the oral argument submitted at the conclusion of his case, it would appear that Defendant has adopted the beliefs of one Larkin Rose as set forth in a videotape called "Theft by Deception," rather than any accepted authority on the interpretation of the tax laws. We are not sure why a C.P.A., in the twilight of his professional career, would embark upon such a path.

The Government next presented the testimony of Jeanette Maggiacomo, I.R.S. Agent with 27 years of experience. Ms. Maggiacomo's mission was to testify relative to the three audits that she performed on tax returns prepared by Defendant. The first audit was of the 1998 and 1999 returns of Charles and Leanna Oliver, both of whom were employed. Defendant prepared a 1998 trust return for Strategic Financial Business Trust that reduced its taxable income to zero by distributing $79,492 for "management services" to the Strategic Financial Management Asset Management Trust. Defendant then prepared a trust return for the Strategic Financial Management Trust that distributed $689,929 in taxable income to the Chico International Trust in Belmopan, Belize. Charles Oliver was listed as the trustee for the Chico International Trust and the two interim trusts used the Oliver's home address. Neither the taxpayers or Defendant provided any proof that any payments were made to the off-shore trust.

The 1999 trust returns prepared by Defendant used the identical modus operandi, the effect of which was to distribute $425,096 in taxable income to the Chico International Trust in Belize. Again, Charles Oliver retained control over the funds as he was listed as the trustee of the off-shore trust. Because neither the 1998 nor 1999 trust scheme divested the Olivers of either control over their businesses or the income stream that resulted, all trust income was attributable to the Olivers. (See Exhibit 8)

Ms. Maggiacomo made two attempts to convince the Olivers that their trust schemes were of the sham variety. The first was to provide them with a copy of I.R.S. Notice 9724. The second was to provide them with copies of I.R.S. Form 4549A, which provided a proper assessment of income taxes for 1998 and 1999. The Olivers turned to Defendant as the one who prepared their returns and Defendant provided no information to I.R.S., which would enable the agency to recompute the tax liability. Instead, Defendant challenged the authority of I.R.S. to question the Olivers' tax returns. Subsequently, the Olivers have retained an attorney and have represented that they intend to amend their returns and pay the appropriate taxes. Ms. Maggiacomo's unchallenged Declaration indicates that the Olivers' representation included penalties and interest. The Court, however, thinks it likely that the Olivers' lawyer has negotiation in mind, especially on the subject of penalties and interest. In any event, Ms. Maggiacomo spent approximately 142 hours in investigative work, all of which is attributable to the preparation of these returns.

Melody Walsh, I.R.S. Agent for 23 years, testified about the audits she performed in reference to returns prepared by Defendant for Charles and Dr. Julianne Swayne in 1999 and 2000. Instead of an off-shore trust used in the Oliver's situation, Defendant used the vehicle of the charitable trust. The Swaynes' Form 1040 contained Schedule C, upon which was a deduction for management or commission fees paid to the Century Asset Trust. The Swaynes also put their income derived from business into the Century Asset Trust and then claimed deductions for personal expenses such as real estate taxes paid, depreciation, mortgage interest, health insurance and repair and maintenance of their personal residence. The remaining taxable income was reduced to zero by "charitable" contributions made by the Century Asset Trust to a charitable trust, the latter of which was controlled by the Swaynes. The analysis of the substance of the transactions showed that the Swaynes never surrendered control over their businesses (Dr. Swayne is a dentist; Mr. Swayne owns rental properties) or the income stream that flowed from

those businesses. (See Exhibit 8)

When the Swaynes were sent a copy of I.R.S. Notice 9724, they promised to and did file amended returns and paid approximately $35,000 in back taxes owed. Due to the Swaynes' immediate cooperation, Ms. Walsh spent approximately 50 hours investigating the abusive trust schemes employed in their case.

Although the testimony focused upon the above-mentioned returns, Plaintiff's exhibits demonstrated similar abusive trust schemes for taxpayers Michael E. Diesel of St. Marys, Kansas (Exhibit 5), Trent and Tamara Schuler of Springfield, Ohio (Exhibit 6), Steven and Joan Welbourn of Brentwood, Tennessee (Exhibit 7) and Ruth Rutledge of Holiday, Texas (Exhibit 8).

We must conclude from the above-stated factual basis that the Government has a substantial likelihood of success on the merits in this case.

EQUITABLE CONSIDERATIONS

What remains to be decided is the effect on Plaintiff if injunctive relief is denied, the effect upon Defendant if it is granted, and the effect on the public interest in either event. It is apparent from the testimony and argument that Defendant does not acknowledge the authority to tax domestic income, nor does he recognize the authority of the I.R.S. to either question the factual basis for which representations are made upon tax returns or to obtain any degree of cooperation from the taxpayer or tax preparer. The impact of this belief upon the Government is obvious. There will be intense interest in all trust returns prepared by Defendant and a lot of time expended by I.R.S. employees in investigating and auditing these returns. In addition, there will be wasted time attempting to obtain taxpayer cooperation, all of which has been demonstrated by past behavior. For those returns that slip between the cracks, there will be a loss of funds in the Government's coffers.

The effect upon the public favors the injunctive relief sought by the Government. Persons who seek the advice of professions are entitled to expressions of opinion that are both defendable, logical and practical. Pursuing sham trust schemes costs the taxpayer unnecessary penalties and interest and subjects the taxpayer to possible criminal penalties.

It is doubtful that the effect upon Defendant would be to put him out of the business. In considering a form of injunctive relief that would be less onerous, the Court recalls the

fundamental belief of Mr. Welti that domestic income is nontaxable. Such a belief would, of necessity, impact the preparation of tax returns in general. However, the Government has not sought the cancellation of Defendant's professional license, nor any prohibition upon other forms of work that accountants typically perform. The Government has not sought a prohibition against the filing of any tax return, but only those returns that intentionally understate income. Mr. Welti, who is in the twilight of his career, would be free to perform other accounting functions. On balance, we find that all the above equitable concerns favor the relief sought by the Government and that a preliminary injunction should issue.

IT IS THEREFORE RECOMMENDED THAT: preliminary injunctive relief shall issue preventing Robert C. Welti, individually, and Bopat Enterprises from:

(1) Preparing federal tax returns or other documents to be filed with I.R.S. that understate taxpayers' liabilities using the Section 861 Argument or other frivolous positions;

(2) Engaging in activity subject to penalty under I.R.C., Section 6700, including organizing a plan or arrangement and making a statement regarding the excludibility of income that he knows or has reason to know is false or fraudulent as to any material matter;

(3) Engaging in activity subject to penalty under I.R.C., Section 6701, including preparing and/or assisting in the preparation of a document related to a matter material to the internal revenue laws that includes a position that he knows will result in the understatement of tax liability;

(4) Failing to retain and produce to the Internal Revenue Service upon request, a list of all clients for whom he performed return preparation services that involve the creation of trusts;

(5) Engaging in any other activity subject to penalty under I.R.C., Sections 6694, 6695, 6700 or 6701; and

(6) Engaging in other similar conduct that substantially interferes with the proper administration and enforcement of the internal revenue laws.

November 8, 2003

Timothy S. Hogan
United States Magistrate Judge

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

United States of America,
Plaintiff,

v.

Case No. C-1-02-243
(Dlott, J.; Hogan, M.J.)

Robert C. Welti,
Defendant.

NOTICE

Attached hereto is the Report and Recommended decision of the Honorable Timothy S. Hogan, United States Magistrate Judge, which was filed on 11/7/02. Any party may object to the Magistrate's findings, recommendations, and report within (10) days after being served with a copy thereof or further appeal is waived. *See United States v. Walters*, 638 F.2d 947 (6th Cir. 1981). Such parties shall file with the Clerk of Court, and serve on all Parties, the Judge, and the Magistrate, a written Motion to Review which shall specifically identify the portions of the proposed findings, recommendations, or report to which objection is made along with a memorandum of law setting forth the basis for such objection, (such parties shall file with the Clerk a transcript of the specific portions of any evidentiary proceedings to which an objection is made).

In the event a party files a Motion to Review the Magistrate's Findings, Recommendations and Report, all other parties shall respond to said Motion to Review within ten (10) days after being served a copy thereof.