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UNITED STATES DISTRICT COURT
DISTRICT OF HAWAII

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UNITED STATES OF AMERICA

UNITED STATES DISTRICT COURT
DISTRICT OF HAWAII

UNITED STATES OF AMERICA,)
)
Plaintiff,)
)
v.)
)
JAMES SCOTT SPARKMAN,)
individually and doing)
business as "MERCURY SOLAR")
and "HAWAII ENVIRONMENTAL)
HOLDINGS"; and THE POWER)
CHANGE COMPANY, LLC,)
)
Defendants.)

CIVIL NO. CV 05 00555
COMPLAINT AND SUMMONS

HG
KSC

COMPLAINT FOR PERMANENT INJUNCTION AND OTHER RELIEF

Plaintiff, United States of America, for its Complaint

against defendants James Scott Sparkman, individually and doing business as "Mercury Solar" and "Hawaii Environmental Holdings," and The Power Change Company, LLC, states as follows:

Nature of Action

1. This action for injunctive relief is brought at the request of 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, pursuant to §§ 7402 and 7408 of the Internal Revenue Code (26 U.S.C.) ("I.R.C.").

Jurisdiction and Venue

2. Jurisdiction is conferred on this Court by 28 U.S.C. §§ 1340 and 1345, and by I.R.C. §§ 7402(a) and 7408.

Defendants

3. Defendant James Scott Sparkman resides in Honolulu, Hawaii. Sparkman does business through The Power Change Company, LLC, Mercury Solar, and Hawaii Environmental Holdings.

4. Defendant The Power Change Company, LLC ("PCC") is a Hawaii limited liability company. PCC's business address is 820 W. Hind Drive, Suite 127, Honolulu, HI 96821. Sparkman is a member of PCC.

5. Sparkman has at different times characterized Mercury Solar in different ways. Mercury Solar LLC, of which Sparkman was a member, was a Hawaii limited liability company created in

May 2001 and administratively terminated in December 2004. Beginning in 1979 and prior to May 2001, Mercury Solar was the name of Sparkman's sole proprietorship. Sparkman has also referred to Mercury Solar as a "pure trust." A "pure trust" is a name used by promoters to describe a fraudulent arrangement designed to hide income from the IRS illegally.

6. Sparkman has at different times characterized Hawaii Environmental Holdings ("HEH") in different ways. HEH was created in July 1992 as a Hawaii general partnership of which Sparkman was an officer. The HEH general partnership was involuntarily cancelled in October 1995. Sparkman also has referred to HEH as a trust and as an "unincorporated business organization." An "unincorporated business organization" is a name used by promoters to describe a fraudulent arrangement designed to hide income from the IRS illegally.

Defendant's Abusive Tax Schemes

7. Sparkman organizes and sells solar energy systems through PCC, HEH, and Mercury Solar.

8. Sparkman first began marketing abusive tax schemes in 1994 to boost sales of his solar energy systems.

The First Abusive Tax Scheme

9. In his first scheme, Sparkman, using Mercury Solar and HEH, sold a solar energy system (typically a hot-water heater) to a customer and received payment in monthly installments.

10. In connection with his sales of the solar energy systems, Sparkman, based on his false characterizations of the transaction, falsely advised his customers to take a federal tax credit to which the customers were not entitled.

11. Sparkman falsely described the installation of the solar energy system as a sale of "energy" by HEH, which he asserted was a trust, to the customer. Sparkman also fraudulently described the customer as a "beneficiary" of HEH.

12. Sparkman contended that HEH was in the business of providing energy and that it qualified for the general business credit for energy property, under I.R.C. §§ 38 and 46. Further, Sparkman contended that HEH, as a purported "trust," could pass through this credit to its "beneficiaries," the customers, who, at Sparkman's direction, improperly took the energy credit on their federal income tax returns.

13. Sparkman and HEH's purported passthrough of the energy credit to the customers was impermissible because the overall transaction was the sale of a solar energy system and no bona fide trust-beneficiary relationship existed between HEH and Sparkman's customers.

14. The United States Tax Court has twice denied Sparkman's customers the energy tax credits that Sparkman claimed passed through to them. See Richter v. Commissioner, 2002 WL 519722, 83 T.C.M. (CCH) 1453 (T.C. 2002); Hvidding v. Commissioner, 2003 WL

21205254, 85 T.C.M. (CCH) 1398 (T.C. 2003).

15. On information and belief, after the Tax Court rulings, Sparkman stopped selling his first abusive tax scheme, but has created a second abusive tax scheme.

The Second Abusive Tax Scheme

16. In his second abusive tax scheme, Sparkman sells multiple solar energy systems (typically, hot-water heaters or refrigerators) to individual customers (the "Participants") living in Hawaii.

17. Sparkman sells a Participant a solar energy system for his house and also sells him a second solar energy system as an investment. The second system is installed in the house of an unrelated third party (the "Renter"). The Participant signs a contract with Sparkman's company, PCC, to manage the Renter's system.

18. Sparkman, through PCC, markets the solar energy systems to the Renters, who pay a fixed, monthly rental fee to PCC.

19. The Renters deal only with Sparkman or a representative of one of Sparkman's companies. Typically, the Renters have no contact with the Participants.

20. The solar energy systems purchased as investments by the Participants entitle them to (a) an energy tax credit pursuant to I.R.C. § 48, and (b) a depreciation deduction for the entire value of the Renter's system pursuant to I.R.C. § 179.

21. Under the passive-activity-loss rule (I.R.C. § 469), losses and credits from passive investment activities cannot be used to reduce income from nonpassive sources, like salaries. Instead, passive activity losses and credits may only be used to reduce income from other passive activities.

22. The Participants' activities in purchasing the solar energy systems as investments and having Sparkman manage the rentals, are passive. Further, the Participants do not materially or actively participate in the activity.

23. Because the Participants' activities are passive, the energy tax credit and the depreciation deduction may be used to offset only the Participants' passive income.

24. Sparkman, however, falsely advises Participants they can offset the deductions and credits against all income.

25. Sparkman also falsely advises Participants that the tax benefits from his scheme are so substantial that Participants "will not owe taxes or will only pay a minimum in taxes."

26. If the Participants properly offset these deductions and credits against passive income only, however, they would realize little or no tax savings, unless they had thousands of dollars of passive income from other sources without any offsetting passive losses.

27. By following Sparkman's advice and offsetting the deductions and credits against non-passive income, the

Participants understate their tax liabilities by thousands of dollars each.

28. Representatives of the IRS have met with Sparkman about this second scheme and have informed him that the scheme is illegal, but Sparkman has refused to stop marketing it.

Damages

29. The IRS estimates that Sparkman had 1,878 participants in his first scheme, with a total estimated tax loss of \$1,471,000.

30. The IRS estimates that Sparkman so far has 150 Participants in his second scheme, with a total estimated tax loss so far between \$340,000 and \$1,047,000.

Count I

Injunction under I.R.C. § 7408 for promoting a abusive tax scheme and aiding and abetting understatements of tax liability

31. The United States incorporates by reference the allegations in paragraphs 1 through 30.

32. Section 7408 of the I.R.C. authorizes a court to enjoin persons who have engaged in any conduct subject to penalty under I.R.C. §§ 6700 or 6701 if the court finds that injunctive relief is appropriate to prevent the recurrence of such conduct.

Violation of Section 6700

33. Section 6700 of the I.R.C. penalizes any person who organizes or sells a plan or arrangement and in connection with that sale makes or furnishes a statement with respect to the

allowability of any deduction or credit or the securing of any other tax benefit which the person knows or has reason to know is false or fraudulent as to any material matter.

34. Defendants organize and sell plans or arrangements that they falsely claim will give customers tax benefits that defendants know or have reason to know are not available.

35. In organizing and selling their plans or arrangements, defendants make false or fraudulent statements regarding the allowability of a deduction and credit, as well as false or fraudulent statements regarding the securing of tax benefits.

36. Defendants know or have reason to know that their abusive tax schemes and the materials promoting them contain false or fraudulent statements within the meaning of I.R.C. § 6700.

37. If defendants are not enjoined, they are likely to continue to organize and sell these and other abusive tax schemes.

Violation of Section 6701

38. Section 6701 of the I.R.C. penalizes any person who advises with respect to the preparation of a portion of a return and who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws and who knows that such portion (if so used) would result in an understatement of the liability for tax

of another person.

39. Defendants advise their customers to take energy tax credits and depreciation deductions against all income on their individual income tax returns, knowing (or having reason to believe) that those credits and deductions will be used in connection with a material matter arising under the internal revenue laws, and also knowing that taking those credits and deductions against all income, instead of against just passive income, would result in understating the tax liabilities of their customers.

40. This Court should enter an injunction under I.R.C. § 7408 to prevent defendants from engaging in conduct subject to penalty under I.R.C. §§ 6700 and 6701, and from engaging in any other conduct subject to penalty under the Internal Revenue Code.

Count II

Injunction under I.R.C. 7402(a) for Unlawful Interference with Enforcement of the Internal Revenue Laws

41. The United States incorporates by reference the allegations in paragraphs 1 through 40.

42. I.R.C. § 7402 authorizes a court to issue orders of injunction as may be necessary or appropriate for the enforcement of the internal revenue laws.

43. Defendants, through the actions described above, have engaged in conduct that interferes substantially with the administration and enforcement of the internal revenue laws.

44. Defendants' conduct results in irreparable harm to the United States because it is causing and will continue to cause substantial revenue losses to the United States Treasury, much of which may be unrecoverable.

45. If defendants are not enjoined, they are likely to continue to engage in conduct that interferes with the enforcement of the internal revenue laws.

46. While the United States will suffer irreparable injury if the defendants are not enjoined, the defendants will not be harmed by being compelled to obey the law.

47. An injunction that stops defendants' illegal activity is in the public interest.

48. An injunction under § 7402(a) is necessary and appropriate.

49. Thus, the United States is entitled to injunctive relief under I.R.C. § 7402(a).

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

A. That the Court find that defendants have engaged in conduct subject to penalty under I.R.C. §§ 6700 and 6701, and that injunctive relief under I.R.C. § 7408 is appropriate to prevent a recurrence of that conduct;

B. That the Court find that defendants are interfering 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 this Court, pursuant to I.R.C. § 7408, enter a permanent injunction prohibiting defendants, individually and doing business under the various names listed in this complaint or under any other name or using any other entity, and defendants' representatives, agents, servants, employees, attorneys, and those persons in active concert or participation with them, from directly or indirectly:

1. Engaging in activity subject to penalty under I.R.C. § 6700, including organizing or selling a plan or arrangement and making a statement regarding the allowability of any deduction or credit, or the securing of any tax benefit, that they know or have reason to know is false or fraudulent as to any material matter;
2. Engaging in activity subject to penalty under I.R.C. § 6701, including advising with respect to the preparation of a portion of a return and who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws and who knows that such portion (if so used) would result in an understatement

of the liability for tax of another person; and

3. Engaging in any other activity subject to penalty under any provision of the Internal Revenue Code;

D. That this Court, pursuant to I.R.C. § 7402(a), enter a permanent injunction prohibiting defendants, individually and doing business under the various names listed in this complaint or under any other name or using any other entity, and defendant's representatives, agents, servants, employees, attorneys, and those persons in active concert or participation with them, from directly or indirectly:

1. Selling or organizing any business arrangement, including the two abusive tax schemes described in this complaint, that encourages or assists noncompliance with the income tax laws, misrepresents the tax savings realized by using the arrangement, or conceals the receipt of income; and
2. Engaging in other similar conduct that substantially interferes with the administration and enforcement of the internal revenue laws;

E. That this Court, pursuant to I.R.C. § 7402(a), require defendants to contact by mail all persons who have purchased the abusive tax schemes described in this complaint and send to them a copy of the permanent injunction against defendants, and to certify to the Court within eleven days of the permanent

injunction that they have complied with this provision;

F. That this Court, pursuant to I.R.C. § 7402(a), enter an injunction requiring defendants to produce to the United States a list identifying the name, Social Security number, address, e-mail address, and phone number of each person who has purchased defendants' tax schemes, plans, arrangements, or programs, and to certify to the Court within eleven days of the permanent injunction that they have complied with this provision;

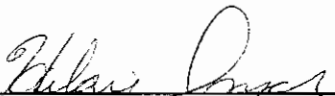
G. That this Court permit the United States to conduct post-judgment discovery to ensure defendants' compliance with the permanent injunction; and

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

DATED: 8.22.05, at Washington, D.C.

Respectfully submitted,

EDWARD H. KUBO, JR.
United States Attorney



HILARIE E. SNYDER
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U.S. Department of Justice