UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

UNITED STATES OF AMERICA, Plaintiff, v. TOBIAS H. ELSASS, SENSIBLE TAX SERVICES, INC., and FRAUD RECOVERY GROUP, INC., Defendants.	No. 2:10cv00336 Judge James L. Graham Magistrate Judge Norah McCann King

DEFENDANTS' ANSWER TO GOVERNMENT'S COMPLAINT

Tobias H. Elsass, Sensible Tax Services, Inc., and Fraud Recovery Group, Inc., (collectively, "FRG") respond to the government's complaint as follows:

AFFIRMATIVE DEFENSE

On behalf of victims of financial frauds, FRG prepares income tax refund claims that are filed with the Internal Revenue Service. These claims are based on Section 165 of the Internal Revenue Code. *See* 26 U.S.C. § 165 (Losses). Section 165 allows people to deduct certain losses sustained during a taxable year that are not compensated for by insurance or otherwise, including losses caused by theft. Claims for such losses are referred to as "theft-loss claims."

In the last four years, the IRS has fully or partially allowed approximately 700 theft-loss claims prepared by FRG. And to date, the government alleges, the IRS has disallowed only 39. Compl. ¶ 65. Assuming for the sake of argument that these 39 claims should have been disallowed, the approval rate for FRG theft-loss claims has nonetheless been greater than 94%. In these circumstances, barring FRG from preparing any tax return, ever again, would make no sense. Indeed, such an injunction would be improper as a matter of law.

RESPONSE TO ALLEGATIONS

For the Court's convenience, the allegations in the complaint are reproduced below, and the answers appear in boldface after each allegation. Any allegation not specifically admitted is denied.

1. The United States brings this complaint pursuant to 26 U.S.C. ("I.R.C.") §§ 7402, 7404, 7407, and 7408 to enjoin the Defendants, doing business as Sensible Tax Services, Inc., FRG or through any other entity, and any other persons in active concert or participation with them, from directly or indirectly promoting the "theft loss" scheme described herein, and from engaging in any other conduct subject to penalty under I.R.C. Sections 6694, 6695, 6700, and 6701, and from engaging in any other conduct that substantially interferes with the proper administration and enforcement of the internal revenue laws.

Answer: Admits that the government has sued under Sections 7402, 7404, 7407, and 7408 of the Internal Revenue Code. Denies the remaining allegations of this paragraph. As an affirmative defense, alleges that the government has failed to state a claim upon which relief can be granted under Section 7404. Section 7404 authorizes the government to bring a civil action for estate taxes, but the government has failed to allege that FRG owes any estate taxes.

2. As described in more detail below, the FRG Defendants are continually and repeatedly urging their customers to claim improper theft-loss deductions under Section 165 of the Internal Revenue Code. In the past two years, there have appeared numerous stories in the news media about massive Ponzi schemes that have cheated taxpayers out of their investments, such as the notorious scheme perpetrated by Bernard Madoff. In proper cases, the Internal Revenue Code provides a mechanism for claiming a deduction reflecting such monetary losses, where the losses can be shown to be the result of actual theft. The FRG Defendants, however, are promoting the Section 165 theft-loss deduction as a panacea for all financial losses, and encouraging their customers (who pay to FRG a fee for its assistance) to claim it regardless of whether theft, or a loss resulting from theft, can be established. The Defendants also encourage their customers to claim the theft-loss deduction prematurely, even when there appears to be a possibility that the taxpayer/customer may receive some compensation for their loss. This improper promotion of the Section 165 deduction should be enjoined under I.R.C. Sections 7402, 7407, and 7408.

Answer: **Admits that people have been cheated out of their investments by Ponzi schemes and other financial frauds, that some of these frauds have been reported by the news media, and that the Internal Revenue Code provides a deduction for such losses in proper cases. Denies the remaining allegations.**

3. In addition, and as part of his overall effort to expand his business promoting theft-loss deductions, defendant Elsass has personally violated several other sections of the Internal Revenue Code. In particular, he has repeatedly, and falsely, held himself out to customers, as well as the IRS, as qualified to represent taxpayers before the IRS in administrative proceedings. In fact, Elsass has had his law license indefinitely suspended for over 10 years, but FRG's customers only learn of this fact at the time of an IRS audit or examination. The FRG Defendants have also violated Section 6695(f) by negotiating and cashing refund checks on behalf of customers in order to extract their "fee" from the sum before sending the remainder to the customer. This conduct also establishes grounds for permanent injunctive relief.

Answer: **Admits that Mr. Elsass's law license was suspended in 1999 and denies the remaining allegations.**

4. This action has been requested by a delegate of the Secretary of Treasury and commenced at the direction of a delegate of the Attorney General of the United States, pursuant to I.R.C. §§ 7402, 7407, and 7408.

Answer: **Lacks knowledge or information sufficient to form a belief about the truth of the allegation, and for that reason denies it.**

5. Jurisdiction is conferred on this Court by 28 U.S.C. §§ 1340 and 1345, and I.R.C. §§ 7402(a), 7407, and 7408. Venue is proper in this Court pursuant to 28 U.S.C. § 1391 and I.R.C. §§ 7407(a) and 7408(a) because a substantial part of the actions giving rise to this suit took place in this district, and also because the FRG Defendants reside in this judicial district.

Answer: **Admits that the Court has jurisdiction pursuant to 28 U.S.C. §§ 1340 and 1345 and I.R.C. § 7402(a). Denies that I.R.C. §§ 7407 and 7408, which authorize the government to bring certain injunction suits, confer any additional jurisdiction on the Court. Indeed, sections 7407 and 7408 state**

explicitly that the Court's jurisdiction rests on I.R.C. § 7402(a). *See* I.R.C. §§ 7407(a) and 7408(a). Admits that venue is proper in this Court.

6. Defendant Tobias H. Elsass is a resident of Columbus, Ohio. In 2006, after working at a Florida-based company also involved in the promotion of Section 165 theft-loss deductions, and learning of the business possibilities of promoting the tax deductions at issue in this case, Elsass opened the FRG business. Elsass signs all original and amended returns he or FRG prepares and puts down his preparer tax identification number.

Answer: Admits that Mr. Elsass lives in Columbus, Ohio, that he first learned about Section 165 and theft-loss deductions while working at JK Harris, that he incorporated Fraud Recovery Group in 2006, and denies the remaining allegations.

7. Defendant FRG is a corporation with its principal place of business at 965 High Street, Worthington, Ohio 43085. FRG was incorporated in January 2006 by Elsass. As its website states, FRG's proclaimed mission is "Recovering Lost Funds for Victims of Investment Fraud" - in particular through its purported expertise with Section 165 of the Internal Revenue Code.

Answer: Denies that FRG's familiarity and experience with I.R.C. § 165 is properly characterized as "purported expertise" and admits the remaining allegations.

8. Defendant Sensible Tax Services, Inc. (which officially employs the trade name "$ensible Tax Services") is a corporation with its principal place of business at 965 High Street, Worthington, Ohio 43085. Upon information and belief, as of 2009, Sensible Tax Services is the entity through which Elsass and FRG prepare and file tax returns for their customers claiming the theft-loss deduction under Section 165. Sensible also prepares income tax returns for customers not claiming theft-loss deductions.

Answer: Admits.

9. Over the past year, the nation's newspapers have been filled with stories detailing numerous instances of financial fraud and Ponzi schemes that have ensnared many investors. (*See, e.g.,* "Madoff Trustee Unveils List of Firm's Customers," *The New York Times,* Feb. 4, 2009 (http://dealbook.blogs.nytimes.com/2009/02/04/madoff-trustee-unveils-list-of-firms-customers/? scp=20&sq=Madoff&st=cse)). Individual investors are understandably upset to learn that financial misconduct may have wiped out investments they believed to be safe. Even worse, getting compensation for these losses from the persons responsible can be an onerous, multi-year process.

Answer: **Admits that people have been cheated out of their investments by Ponzi schemes and other financial frauds, and that some of these frauds have been reported by the news media. Lacks knowledge or information sufficient to form a belief about the truth of the remaining allegations, and for that reason denies them.**

10. The Internal Revenue Code includes a provision by which a taxpayer who has been the victim of a theft loss may claim as a deduction the full amount of the loss he has suffered at the time of discovery. I.R.C. § 165(c)(3). This is in contrast to the capital loss deduction available to those whose investments decline simply as a result of market forces or financial mismanagement. A capital loss deduction is capped at a rate of $3,000 per year as against ordinary income (I.R.C. § 1211), meaning that a taxpayer who has suffered a true theft loss will receive tax benefits for his loss through the Internal Revenue Code much more quickly than if he simply declared a series of capital losses over time. However, as with all deductions, the taxpayer claiming a theft loss must be able to verify and substantiate it in all respects, *i.e.* that a theft did in fact occur; that the claimed amount is correct; and that the theft-loss deduction has been otherwise reported at the time and in the manner consistent with the terms of Section 165.

Answer: **Paragraph 10 consists of legal arguments, interpretations, and conclusions for which no response is required.**

11. The FRG Defendants have developed a tax-related business premised upon their purported expertise in the application and construction of Section 165, and their resulting proficiency in determining when such a deduction may be taken by an appropriate taxpayer. They claim to possess a team of tax professionals, certified fraud examiners, and other legal experts, all of whom help investors who lose money in financial scams or due to brokerage misconduct. Through direct marketing aimed at taxpayers identified by the Defendants as having been the victim of some financial loss, the FRG Defendants begin by purportedly "educating" their potential customers about the theft-loss deduction. They next sell their services to such taxpayers -- starting with the "neutral" evaluation of whether such a deduction is available, and then ending in the preparation of the necessary tax documents (whether original or amended returns) to claim the deduction and, if necessary, to defend it if the customer is audited by the IRS.

Answer: **Denies that FRG's familiarity and experience with Section 165 is properly characterized as "purported expertise." Denies that FRG claims to possess a team with certified fraud examiners. Denies any**

implication, arising from the use of the word "claim," that FRG does not possess a team of tax professionals and other legal experts. Denies any implication, arising from the use of quotation marks around the words "educating" and "neutral," that FRG does not properly inform its clients about theft-loss deductions and does not objectively evaluate whether theft-loss deductions are available under Section 165. Admits the remaining allegations.

12. As a result of their persistent efforts, over the past several years the FRG Defendants have extracted fees from their customers in the hundreds of thousands of dollars as they spread the word among taxpayers that their company has the expertise necessary to obtain for its customers this theft-loss deduction, and thereby provide them some relief from their financial loss. The FRG Defendants have even advertised their services on a nationally-placed television advertisement. *See* http://www.fraudrecoverygroup.com/tv.html.

Answer: Denies that FRG's efforts were "persistent," that their fees were "extracted," and that the "financial" losses at issue were not theft losses within the meaning of Section 165. Admits the remaining allegations.

13. In fact, however, the promises of the FRG Defendants are illusory. The IRS has determined that the FRG Defendants' Section 165 expertise is mainly limited to marketing to potential customers their Section 165-related services, and then quickly preparing the necessary tax return filings to claim a theft-loss deduction. When it comes to actually *evaluating* whether a customer is entitled to claim a theft-loss deduction, or can properly substantiate that deduction to the IRS, however, the FRG Defendants prove to have no expertise at all. Instead, they rely on conclusory and boilerplate determinations that the theft-loss deduction is proper for a given customer -- in particular, by assuming a loss meets the statutory definition of theft, even where that is plainly not the case. As a result, the FRG Defendants only assist their customers in making false theft-loss claims that the IRS later disallows on audit.

Answer: Denies.

14. The FRG Defendants' goal is not to provide their customers with proper advice about the availability of a theft-loss claim, but instead to obtain the lucrative fees that come from providing the theft loss "analysis." In so doing, the FRG Defendants mislead their customers as to what their real tax liability should be. Indeed, even after the IRS has disallowed a particular theft-loss claim, Elsass will do all he can to evade his up-front promise to refund fees paid in advance, preferring instead to engage in protracted appeals processes no matter how baseless.

Answer: **Denies.**

15. These erroneous, unsubstantiated theft-loss claims reflect a persistent scheme in which the FRG Defendants have caused their customers to claim theft-loss deductions that they should not have claimed. Accordingly, the improper conduct of the FRG Defendants rendered their customers victims twice over - first of the financial loss that led them to first seek the FRG Defendants' services, and then of the fraudulent scheme perpetrated by the FRG Defendants (in the name of remedying the initial fraud). Their conduct results in the preparation of federal income tax returns that the FRG Defendants know or have reason to know will result in the understatement of their customers' tax liability. The United States brings this action in order to prevent FRG Defendants from continuing to engage in this illegal conduct.

Answer: **Lacks knowledge or information sufficient to form a belief about the truth of the allegation regarding the government's purpose in bringing this suit, and for that reason denies it. Denies the remaining allegations.**

16. In addition to the above, Defendant Elsass (whose license to practice law in Ohio is at present indefinitely suspended) has personally engaged in misconduct violative of several different sections of the Internal Revenue Code. In particular, Elsass has repeatedly and continually submitted false Power of Attorney Forms 2848 to the IRS representing that he is an attorney authorized to practice law in his state when he is not. In addition, the fact that Elsass's law license is suspended also makes him disqualified to represent customers before the IRS as an unenrolled return preparer either - yet he has continually identified himself as an unenrolled return preparer on numerous Forms 2848 he has signed for his customers. Elsass has been notified several times by the IRS to cease such conduct, but he has not done so. He has also repeatedly, in violation of Section 6695(f) of the Internal Revenue Code, cashed his customers' refund checks and withdrawn from them FRG's fee before forwarding their refunds derived from a theft-loss deduction. For such misconduct, on top of his knowing and repeated inclusion of false theft-loss deduction claims in the tax returns he prepares, and given the almost certain likelihood it will continue absent entry of an injunction, Elsass should be permanently enjoined from preparing tax returns for others.

Answer: **Denies.**

17. Under I.R.C. § 165(a), a taxpayer may claim a deduction for a loss sustained during the taxable year and not reimbursed by insurance or otherwise. Section 165(c) specifically permits this deduction for a "theft loss," which has been defined by applicable regulations to include larceny, embezzlement, and robbery. (I.R.C. § 165 (c)(3); *see also* Treas. Reg. § 1.165-8(d)). When properly claimed, a theft-loss deduction permits a taxpayer to deduct the entire amount of the loss (minus a specified threshold amount) in the year in which it is incurred, as opposed to some capped amount or percentage, such as when a capital loss is claimed. In

addition, under Section 172, the taxpayer can carry the theft loss back to prior tax years.

Answer: Paragraph 17 consists of legal arguments, interpretations, and conclusions for which no response is required.

18. As with all deductions, the taxpayer bears the burden of establishing an entitlement to a theft-loss deduction. To meet this burden, a taxpayer must be able to establish that (1) the loss was the result of a "taking of property" that is illegal under the laws of the state where the loss occurred, and (2) the taking was done with criminal intent. (See Rev. Rul. 71-381, 1971-2 C.B. 126).

Answer: Paragraph 18 consists of legal arguments, interpretations, and conclusions for which no response is required.

19. In 2009, the IRS issued a revenue ruling and related revenue procedure that clarifies what kinds of losses can properly be said to be the result of theft. (*See* Rev. Rul. 2009-9, 2009-14 I.R.B. 735 and Rev. Proc. 2009-20, 2009-14 I.R.B. 749). That Revenue Procedure defines a "qualified loss" to be one that is the result of a 'fraudulent arrangement' in which one or more of the individuals allegedly responsible for the fraud have been "charged by indictment or information ... under state or federal law with the commission of fraud, embezzlement, or a similar crime" meeting the definition of theft. (Rev. Proc. 2009-20 at Section 4.02(1)). Alternatively, a qualified loss exists where the lead figure is the subject of a state or federal criminal complaint alleging a "theft" as defined in Section 165 and either (a) the complaint alleges an admission by the lead figure or the execution of an affidavit by that person admitting the crime, or (b) a receiver or trustee has been appointed with respect to the arrangement at issue and/or its assets have been frozen. (*Id.* at Section 4.02(2)). By their own terms, these guidance items apply to losses for which the discovery year is after December 31, 2007.

Answer: Paragraph 19 consists of legal arguments, interpretations, and conclusions for which no response is required, but admits that the IRS issued Revenue Ruling 2009-9 and Revenue Procedure 2009-20 in 2009.

20. Accordingly, a theft-loss deduction cannot simply be based on the bald assertion that a theft appears to have occurred, supported by circumstantial proof like the fact that an entity has filed for bankruptcy or receivership under a cloud of suspicion. Rather, there needs to be concrete persuasive proof that the loss is the result of theft.

Answer: Paragraph 20 consists of legal arguments, interpretations, and conclusions for which no response is required.

21. Relevant Treasury regulations also establish rules about the proper time for claiming a theft-loss deduction. Section 165 obligates taxpayers to claim the theft loss in the "taxable year in which the taxpayer discovers such loss." I.R.C. § 165(e). However, if at the time of discovery there exists a claim for reimbursement of the loss "with respect to which there is a reasonable prospect of recovery," the theft-loss deduction should not be claimed in that year. Treas. Reg. § 1.1658(a)(2). The loss may not be claimed "until it can be ascertained with reasonable certainty" that reimbursement will not occur. Treas. Reg. § 1.165-1(d). The kinds of factors that suggest "with reasonable certainty" that all or part of a loss will not be reimbursed are events such as the adjudication, settlement, or abandonment of the claim. Treas. Reg. § 1.165-1(d)(2) (I). The existence of a bankruptcy, receivership, or other organized and monitored process for marshaling the assets of the party or entity who committed the underlying fraud, so that victims of the scheme can have some of their losses reimbursed, has been consistently viewed, by the IRS as well as federal courts, as an indicator that a theft loss should not be claimed. Rather, the loss can only be claimed once it can be "ascertained with reasonable certainty" what precise percentage of the victim's loss can be reimbursed.

Answer: Paragraph 21 consists of legal arguments, interpretations, and conclusions for which no response is required.

22. Given the above, the mere availability of the theft-loss deduction in the pages of the Internal Revenue Code does not mean that it may be lawfully claimed whenever a taxpayer suspects he is the victim of some fraudulent investment scheme. On the contrary - and taking into account the magnitude of the deduction that is permitted in appropriate theft loss cases - it is paramount that those taxpayers claiming this deduction not only be able to meet the statutory and regulatory grounds for it, but also that they be able to adequately substantiate to the IRS that they have correctly claimed the deduction. The FRG Defendants simply ignored these concerns, while holding themselves out to customers as experts on the topic of theft-loss deductions.

Answer: Paragraph 22 consists of legal arguments, interpretations, and conclusions for which no response is required. Denies the remaining allegations.

23. Before his entry into the business of theft-loss-deduction analysis and promotion, Elsass was a working attorney specializing in divorce proceedings. However, his professional license to practice law in the State of Ohio has been suspended on at least three occasions for a variety of misconduct, beginning in 1995. Elsass was suspended indefinitely from the practice of law by the Ohio Supreme Court in 1999, and he has not been reinstated since that time. Nevertheless, Elsass has continued to hold himself out to the IRS via a Form 2848 (as recently as January of 2010) as authorized to represent his customers in administrative proceedings, either as an attorney or unenrolled return preparer - even doing so after being pointedly informed by the IRS that this was not the case and he should cease such representations.

Answer: The second sentence of paragraph 23 should be stricken

because it is immaterial, impertinent, and scandalous. The number of times that Mr. Elsass's law license was suspended and the reasons for those suspensions are immaterial and impertinent because they are not relevant to the issues in this tax injunction action. The allegation is scandalous because it implies that Mr. Elsass must have violated the internal revenue laws because his law license was suspended three times. The implication, in other words, is that Mr. Elsass is of poor character and he acts in conformity with that poor character. As such, Rules 402 and 404 of the Federal Rules of Evidence bar admission of evidence in support of this allegation, and Mr. Elsass will be prejudiced if the allegation is not stricken pursuant to Rule 12(f)(1) of the Federal Rules of Civil Procedure.

Denies any implication, arising from the use of the word "promotion," that FRG promoted an abusive tax shelter. Admits that a Form 2848, in which Mr. Elsass is identified as an unenrolled return preparer, was filed in January of 2010. Admits that Mr. Elsass represented clients in divorce proceedings, which often present federal tax issues. Denies the remaining allegations.

24. After losing his license to practice law, Elsass concentrated on the management of certain rental properties he owned, and then began to purchase and remodel foreclosed properties for Eastern Bank. Eventually, however, Elsass needed a regular job to meet his financial needs, and began looking for such a position.

Answer: The allegations of paragraph 24 should be stricken because they are immaterial and impertinent. Mr. Elsass's occupation and his financial needs at that time are immaterial and impertinent because they are not relevant to the issues in this tax injunction action. As such, Rule 402 of

the Federal Rules of Evidence bars admission of evidence in support of this allegation, and Mr. Elsass will be prejudiced if the allegation is not stricken pursuant to Rule 12(f)(1) of the Federal Rules of Civil Procedure.

25. In 2002, Elsass worked for JK Harris 165 Services in Tampa, Florida as a salesperson for its "product" -- packaging theft-loss deductions to taxpayers. That entity (today known as "165 Services, Inc.") was engaged in the same business promoting theft-loss deductions as FRG. The company had a research staff responsible for looking for fraudulent investment schemes (given that the victims of such schemes were potential customers). It would then target such individuals, through advertising, cold calling, or seminars, and advise them of the availability of the Section 165 deduction. The goal of 165 Services was to be engaged by such investment fraud victims to "analyze" whether the customer had a theft-loss claim (almost invariably the answer was yes), and then to also provide such victims the tax preparation services necessary to claim the theft-loss deduction.

Answer: Admits that Mr. Elsass worked for JK Harris 165 Services in Tampa in 2002. Denies that Mr. Elsass was a salesperson for a "product" packaging theft-loss deductions. Denies any implication, arising from the use of the word "promoting," that FRG promoted an abusive tax shelter. Lacks knowledge or information sufficient to form a belief about the truth of the remaining allegations, and for that reason denies them.

26. While employed at 165 Services, Elsass learned a great deal about the business of promoting theft-loss deductions for profit. Prior to his employment at 165 Services, Elsass had limited experience in advising individuals about tax matters, and minimal exposure to securities matters as well. However, through his position Elsass learned not only of the Section 165 deduction, but also the business model for promoting the deduction to unsuspecting victims of financial fraud. During this time he also took some basic tax preparation classes at H & R Block.

Answer: Admits that Mr. Elsass first learned about Section 165 and theft-loss deductions at JK Harris, that he had minimal exposure to securities matters, and that he took some tax preparation classes at H&R Block. Denies the remaining allegations.

27. Elsass's responsibilities at 165 Services included obtaining customers in the Ohio region. He was paid commissions for each customer he obtained, in amounts varying from 30 percent of the fee to 15 percent (his success resulted in the commissions being reduced over time). Elsass would research financial schemes in the newspapers and then attempt to contact the victims of such schemes in order to sell to them the theft-loss deduction.

Answer: **Denies that Mr. Elsass "sold" clients a "theft-loss deduction." Admits the remaining allegations.**

28. Elsass was fired from 165 Services in December 2005 as part of an internal shake-up of the organization. He promptly saw an opportunity, however, and immediately formed his own company, FRG, in 2006, as a vehicle for employing the business model he had learned while at165 Services. Elsass operated FRG out of his home until the end of 2008, when he moved the business to its current address. FRG has during the relevant time period employed on average 15 to 20 people.

Answer: **Admits that Mr. Elsass formed FRG in 2006 to help clients with theft-loss claims. Admits that FRG operated out of Mr. Elsass's home until the end of 2008, when FRG moved to its current address. Denies the remaining allegations.**

29. The first "stage" of the theft-loss deduction promotion is the identification of potential customers who may have suffered a financial loss. Elsass conducts his own research (often by reading newspapers) to look for instances of alleged securities fraud or investor fraud that are of sufficient scope and magnitude to generate large losses for numerous investors. He also employs a number of researchers to aid him in this task.

Answer: **Admits that Mr. Elsass and other FRG employees conduct research as described. Denies the remaining allegations.**

30. In order to identify people that could become FRG customers, Elsass looks in particular for schemes that result in bankruptcy filings, or lawsuits and arbitrations in which the victims of the scheme were creditors or parties; from these, he could obtain the names and addresses of potential customers. It is also important to FRG to identify potential customers with sufficient basis in a lost investment, so that it could ensure that the theft-loss deduction they would later claim would be high enough to secure for FRG the fees it desires. (Notably, however, as his hunger for fees has increased, Elsass has proven less concerned with the degree of true basis in an investment scheme, and only looked instead for proof of some sort of investment loss, regardless of whether the losses are truly the measure of the investor's basis as defined under the Internal Revenue Code.)

Answer: **Admits the allegation in the first sentence. Denies the remaining allegations.**

31. FRG next attempts to contact these prospective customers, primarily through direct mailings of pamphlets describing its services. If a customer expresses interest in FRG's services, FRG sends him a questionnaire and engagement form. FRG conducts no evaluation to determine if a prospective customer could legitimately claim a theft-loss deduction, however; all "analysis" of the propriety of making the theft-loss deduction claim was performed when FRG was looking for customers to contact. FRG assumes from the outset that any interested customer it has identified can legitimately claim a theft-loss deduction (especially if the anticipated refund was likely to produce a large fee for the FRG Defendants), and it conveys that assumption to its customers.

Answer: **Admits the allegation in the first sentence. Denies the remaining allegations.**

32. FRG charges two different fee structures for "assisting" customers with the processing of a theft-loss claim. Customers can either enter into an up-front "cash" contract, in which they pay in advance a fee of 15 percent of the anticipated refund (half in advance based on the estimated refund, with the second half after the refund is actually obtained), or a "deferred" contract, in which the customer pays 30 percent of the refund actually received (recently raised to 35 percent), with the fee being extracted from the customer's refund check by Elsass. FRG and Elsass specifically warrant that these fees will be refunded if the theft-loss claim does not result in a tax refund, a fact that has enticed many taxpayers to participate in the promotion since they saw no downside even if the deduction was disallowed. In either case, the FRG Defendants require their customers to sign a Form 2848 giving Elsass specifically power of attorney as the given customer/taxpayer's representative.

Answer: **Admits that clients who hire FRG generally pay either 15% of the anticipated refund or 30% to 35% of the refund actually received. Admits that FRG will refund any fee paid if the theft-loss claim does not result in a tax refund. Denies the remaining allegations.**

33. Once a customer agrees to FRG's contract and signs the necessary forms and documents, FRG does little else to analyze the propriety of the Section 165 theft-loss deduction. In some cases, additional information from the customer is required, and FRG employees accordingly contact the customer by phone for that purpose. Otherwise, the Defendants simply prepare a Form 1040 or 1040X amended return (if a theft loss is being carried back to prior tax years) for the customer and have it filed. The FRG Defendants simply assume a customer they have identified at the outset is entitled to a theft-loss deduction.

Answer: **Admits that, because FRG determines whether a potential client has a valid theft-loss claim before sending a contract, it may not perform any additional analysis after a client signs a contract. Alleges that FRG sometimes does perform additional analysis after a client signs a contract. Denies the remaining allegations.**

34. Early in the history of FRG, Elsass subcontracted the preparation of the Forms 1040 and 1040X to Liberty Tax Service, a company in Ohio, although Elsass personally reviewed all such returns and signed them (his preparer tax identification number and signature appear on all such returns). Later, Elsass had FRG directly prepare the relevant income tax returns. In 2009, Elsass formed his own tax-preparation entity, Sensible Tax Services, to prepare the returns for FRG theft-loss claimant customers as well as prepare returns for taxpayers who simply want tax preparation assistance generally without claiming a theft-loss deduction.

Answer: **Denies that Mr. Elsass signed all tax returns. Admits the remaining allegations.**

35. As a general matter, FRG has often urged its customers to claim theft-loss deductions based upon pure investment losses -- which, as a matter of law, do not meet the definition of theft in any regard. As a result, the IRS has disallowed theft-loss deductions for numerous FRG customers who were falsely advised that their pure investment loss was actually the result of theft. However, even when a particular scheme pre-identified by Elsass appears likely (at least under the more recent IRS theft-loss guidelines) to fit the definition of theft, the resulting Section 165 deductions claimed for the FRG Defendants' customers are still disallowed for failing to meet the requirements of Section 165.

Answer: **Denies.**

36. In general, Section 165 permits a taxpayer claiming a theft-loss deduction to measure the deduction by the customers' adjusted basis in the property that was lost. I.R.C. § 165(a). The 2009 guidances pertaining to the theft-loss deduction underscore this point, noting that basis must be reduced by any investment sums reimbursed to the taxpayer. Rev. Proc. 2009-20.

Answer: **Paragraph 36 consists of legal arguments, interpretations, and conclusions for which no response is required.**

37. The Defendants have targeted a large number of customers who were the victims of an investment scheme promulgated by Pacific Wealth Management and Stonewood Consulting ("Pacific Wealth"). The Pacific Wealth scheme involved the purchase of large numbers of residential properties in the names of their investors, who in most cases provided some initial

funds to be applied toward the down payments for the properties (often obtained by taking large cash advances from credit cards which the promoters of the Pacific Wealth scheme urged its investors to obtain). The intent of the scheme was to "flip" the properties within a short period of time, with the entities making the mortgage payments on behalf of investors and otherwise managing the purchased properties on behalf of their nominal owners.

Answer: **Admits that FRG contacted victims of the Pacific Wealth financial fraud and helped them report valid theft-loss deductions, 5 of which were allowed by the IRS, 3 of which were denied, and 36 of which are still being processed by the IRS. Lacks knowledge or information sufficient to form a belief about the truth of the intent of Pacific Wealth, and for that reason denies the allegation. Admits that the description of the Pacific Wealth fraud is otherwise basically correct. Denies the remaining allegations.**

38. The Securities and Exchange Commission eventually charged the promoters of the Pacific Wealth scheme with the unregistered offer and sale of securities as well as several other counts of securities fraud. The promoters of the Pacific Wealth scheme have also been criminally charged as of the fall of 2009. However, the mere fact that this scheme might meet the definition of "theft" under the Internal Revenue Code does not mean that victims of the scheme suffered a loss as a result of the misconduct. This is particularly the case with the Pacific Wealth scheme, where the individual investors' losses were measured by the credit card debt they incurred in order to advance funds to the promoters of the scheme. Such losses constituted minimal basis in the purchased properties; moreover, many of the investors successfully discharged these losses in bankruptcy proceedings. As a result, the IRS has repeatedly disallowed the theft-loss deduction claimed for a Pacific Wealth investor on the grounds that the amount of the deduction (which the FRG Defendants typically measured by the total value of the properties purchased in the scheme) has not been adequately substantiated.

Answer: **Admits that the perpetrators of the Pacific Wealth fraud have been investigated by the SEC and criminally charged. Denies that the IRS has repeatedly disallowed the Pacific Wealth theft-loss claims of FRG clients. The IRS has allowed 5 refund claims and denied 3. Lacks knowledge or information sufficient to form a belief about the truth of the remaining**

allegations, and for that reason denies them, including the allegation that the IRS has repeatedly disallowed the theft-loss claims of Pacific Wealth victims who are not clients of FRG.

39. Doubts as to whether sums invested in this scheme truly constituted theft losses never prevented the FRG Defendants from making theft-loss claims on behalf of Pacific Wealth investors. For example, the FRG Defendants prepared, and Elsass signed, amended income tax returns for Tommy and Moraima Simmons of San Diego, California for the 2003-2006 tax years claiming a theft-loss deduction of $629,000. This theft-loss deduction was based on losses the Simmonses experienced in connection with their participation in the Pacific Wealth scheme. The Simmonses could not, however, establish that they actually had basis in that amount in the relevant properties that had been purchased in their names through the scheme. Rather, the $629,000 figure simply reflected the amount of the mortgages on the relevant properties rather than the true value of the Simmonses' investments in those properties. The Simmonses could establish no more than $9,000 in lost invested sums, most of which reflected credit card cash advances. Accordingly, the IRS disallowed completely this theft-loss deduction.

Answer: Admits that FRG helped the Simmonses, who were victims of the Pacific Wealth fraud, make a theft-loss claim. Admits that the IRS disallowed this claim. Denies the remaining allegations.

40. Micah and Tracie Galtney of Surprise, Arizona, also retained the FRG Defendants to assist them in amending their tax returns from prior years to claim a theft-loss deduction resulting from their investment in the Pacific Wealth scheme. In February 2008, Elsass filed for the Galtneys an amended 2006 income tax return claiming a theft loss in the amount of $250,000 and carrying the loss back three years and forward one year. In December 2008, the IRS disallowed the deduction because the Galtneys had failed to substantiate their claimed basis of $250,000. Not only had the Galtneys invested no more than $83,000 with Pacific Wealth (a third of the theft-loss deduction claimed), but also some of their indebtedness on the mortgages for the properties purchased through the scheme had been discharged in a bankruptcy proceeding the Galtneys had initiated, further reducing their basis.

Answer: Admits that FRG helped the Galtneys, who were victims of the Pacific Wealth fraud, make a theft-loss claim. Denies that FRG knew about the Galtneys' bankruptcy, which the Galtneys filed after FRG helped them make the theft-loss claim. Admits that the IRS disallowed this claim. Denies the remaining allegations.

41. The FRG Defendants also urged their customers to claim theft-loss deductions based on the year that would be most favorable to them from a tax standpoint - or to Elsass from a profit standpoint. Under Section 165, a taxpayer must wait to claim the loss until it can be "ascertained with reasonable certainty" that the prospect of recovery is in fact remote, and/or until it is evident what recovery the taxpayer can expect from pending efforts to recover stolen funds. The recently-released theft loss guidances (applying to theft losses incurred after December 2007) liberalize this somewhat, allowing taxpayers to claim the theft loss in the year in which the investment scheme's promoters are indicted or otherwise the subject of a state or federal criminal complaint. Rev. Proc. 2009-20 at 5.01(2). The FRG Defendants, however, routinely ignored these standards.

Answer: Paragraph 41 includes legal arguments, interpretations, and conclusions for which no response is required. Denies the remaining allegations.

42. For example, the FRG Defendants prepared a Form 1040X amending the 2007 income tax return for Joseph and Mary Sultana claiming a theft-loss deduction of $1,438,688 stemming from sums allegedly stolen from the Sultanas in connection with the Transcontinental Airlines Ponzi scheme promulgated by former "boy band" impresario Lou Pearlman. Even though this scheme appears to meet the definition of a "theft loss," it still must be claimed in accordance with the terms of Section 165 and all applicable regulations. The FRG Defendants did not meet these standards in claiming a theft loss for the Sultanas in 2007 (incurred prior to the liberalized theft loss procedures), because Transcontinental Airlines was still in receivership at that time (and remains so today) and therefore the Sultanas were likely to recover some of their lost investment. In short, it could not be "ascertained with reasonable certainty" that the Sultanas would recover no more of their loss.

Answer: Admits that FRG helped the Sultanas, who were victims of the Transcontinental Airlines fraud, prepare a theft-loss claim. Denies the remaining allegations, and alleges that the IRS allowed the Sultanas' theft-loss claim.

43. The FRG Defendants are aware that claiming theft losses in different years can have different tax effects for their customers -- and the Defendants will charge extra if a customer wants to claim the deduction in a year that will maximize his tax benefits. In marketing their services, the FRG Defendants specifically inform potential customers who have been pre-identified as victims of a particular scheme that their time to assert a theft-loss claim in the most favorable year may be running out. The FRG Defendants also specifically prepared an internal document entitled "YOD for Scams," in which they set forth the proper "year of discovery" for reporting theft losses relating to particular financial scams or Ponzi schemes. As notations on this document indicate, the Defendants were willing to consider reporting certain theft losses as

occurring in earlier years, provided that the customer at issue had (a) agreed to the "deferred" higher fee rate of paying 30 percent of the refund, and (b) expected to report a loss in excess of $100,000. What mattered to the Defendants was not accurate claiming of theft-loss claims, but getting a large fee and getting it sooner.

Answer: Admits the allegation in the second sentence. Admits the allegation in the third sentence but alleges by way of qualification that the internal document mentioned set forth the presumptive year of discovery—which may or may not have been the year of discovery for a particular taxpayer—based on FRG's good faith analysis at the time. Denies the remaining allegations.

44. Besides promotion of improper theft-loss deductions, the FRG Defendants have consistently attempted to increase the size of the refunds their customers are to receive (and as a result, FRG's fees) through other violations of the Internal Revenue Code.

Answer: Denies.

45. For example, theft-loss claims generally are (to the extent they have any validity at all) properly reported as Miscellaneous Deductions on a Schedule A. Elsass, however, instructed in certain cases that the loss should be reported on a Form 4797 (for claiming sales of business property). The purpose for doing so was twofold. First, utilizing a Form 4797 would help reduce the taxpayer's Adjusted Gross Income ("AGI"), allowing the taxpayer to realize larger deductions to which they otherwise would not have been entitled if properly reported on a Schedule A.

Answer: Admits that theft losses are often reported on Schedule A. Admits that for some clients FRG reported theft-loss claims on Form 4797. Denies the remaining allegations.

46. Second, claiming the theft loss on a Form 4797 was a means of generating a larger state tax refund for the theft-loss year. After the FRG Defendants had filed a customer's amended federal income tax return with the IRS in which the theft loss was reported on a Form 4797, they would also file an amended state return (based on the improper claiming of a theft loss on the Form 4797). Thereafter, even if the IRS adjusted the amended federal return so that the theft loss was properly reported on a Schedule A, the FRG Defendants would not inform the relevant state of the change, but would instead pursue the state refund as if what had originally been filed with the IRS was correct.

Answer: **Denies.**

47. In addition, the FRG Defendants also repeatedly filed amended returns for taxpayers claiming theft losses even though the customer had provided them information establishing that the loss had been suffered by a third party. For example, Elsass prepared and signed amended returns claiming theft losses for a customer relating to investments that had been made for the customer's child, and in the child's name, under the Uniform Gift to Minors Act. Conversely, other Elsass customers attempted to claim theft-loss deductions for losses a parent had realized, based upon the concept that the customer had "inherited" the loss.

Answer: **Denies.**

48. Other of the FRG Defendants' practices were even more blatant. They frequently inflated the size of theft losses beyond what the customer could substantiate with documentation. And they claimed losses for certain customers without regard for the fact that the customer at issue had in fact already received some reimbursement for the loss, such as through a receivership set up to deal with a particular investment scam, or through personal bankruptcy (for victims of the Pacific Wealth scheme in particular, whose losses were the direct result of large credit card advances, but where the customers' credit card debts were often discharged through bankruptcy).

Answer: **Denies.**

49. The FRG Defendants also engaged in other kinds of tax preparation fraud that did not relate directly to the theft loss claim (but would nevertheless increase the anticipated refund, and hence the expected fee). Thus, for amended returns prepared claiming theft losses for the victims of the Pacific Wealth and High Park investment scams, interest and property taxes paid by the customer for their personal residences were in many cases moved from a Schedule A and instead to a Schedule E- even though the customer never had any rental income from her personal residence, and rarely any rental income from another property. This was done solely to generate a larger Net Operating Loss (NOL), and thus a larger refund. Charitable deductions for such customers were similarly reported on Schedules E for the same rationale. In addition, Elsass and Sensible Tax Services often prepared amended tax returns for wage-earning employees in which unreimbursed employee expenses were reported on a Schedule C rather than a Schedule A, as a means of evading the limitations on deductions that would otherwise be imposed by the Alternative Minimum Tax.

Answer: **Denies.**

50. As noted above, Elsass is not authorized to represent his customers before the IRS, either as an attorney or an unenrolled tax preparer, given that his license to practice law has been indefinitely suspended. *See* 31 C.F.R. §§ 10.50 and 10.51(i) (2007) (suspension of attorney license constitutes "incompetence and disreputable conduct" that is grounds for suspension of practice in representing customers before the IRS); Rev. Proc. 81-38, 1981-35 I.R.B. 12, at Sec. 9.01(b) (individuals suspended from practice as attorneys are ineligible to engage in limited practice as a taxpayer's representative (such as in the capacity of an unenrolled tax preparer)

before the IRS). In 2009, after it learned of Elsass's indefinite suspension from the Ohio bar, the IRS's Office of Professional Responsibility formally listed Elsass as ineligible for a Centralized Authorization File number (issued by the IRS to individuals who are authorized to appear on behalf of taxpayers and who are identified as a taxpayer representative in a Form 2848).

Answer: **Lacks knowledge or information sufficient to form a belief about the truth of the allegations regarding the IRS Office of Professional Responsibility, and for that reason denies them. Denies the remaining allegations.**

51. Despite the above, Elsass has repeatedly had his customers fill out and sign Forms 2848 in which he represents that he ***is*** so authorized. And he does not inform his customers that he lacks the capacity to represent them until after (in the course of an examination of a theft-loss deduction claim he has asserted on behalf of the customer) they learn the truth. To the contrary - his customers believe at the outset of engaging FRG that Elsass is a fully licensed attorney, a misunderstanding he actively encourages.

Answer: **Denies.**

52. For example, Joseph and Ann Harrington of North Reading, Massachusetts retained FRG to prepare and file amended income tax returns claiming a theft-loss deduction for tax year 2005 stemming from the Harringtons' investment losses in the American Business Financial Services scam. On the February 2008 Form 2848 initially submitted to the IRS in connection with the Harringtons' filings, Elsass affirmatively represented that he was an attorney. Later that same year, in August 2008, Elsass submitted another Form 2848 indicating he was an unenrolled return preparer, but further identifying Deborah Percell of Chico, California as an enrolled agent representing the Harringtons.

Answer: **Denies that conduct alleged in paragraph 52 is an example of the conduct alleged in paragraph 51, but otherwise admits the allegation in the first sentence. Lacks knowledge or information sufficient to form a belief about the truth of the allegation in the second sentence, and for that reason denies it. Admits that a Form 2848, in which Mr. Elsass is identified as an unenrolled return preparer and Ms. Percell is identified as an enrolled agent, was submitted in August of 2008.**

53. The IRS subsequently advised the Harringtons in a letter dated September 11, 2008, that Elsass could not represent them given the indefinite suspension of his attorney license. Elsass received a phone call from the IRS that same day on this topic, followed by a letter dated September 17, 2008 in which he was specifically informed he could not appear before the IRS on behalf of his customers. Mere months before, in July 2008 (after the Harringtons had learned their claims were being disallowed), Elsass had written to the IRS on the Harringtons' behalf protesting the decision.

Answer: Admits that the IRS sent the Harringtons a letter dated September 11, 2008, stating that Mr. Elsass was not eligible to represent them, that Mr. Elsass received a letter from the IRS dated September 17, 2008, on this topic, and that Mr. Elsass sent a letter to the IRS on behalf of the Harringtons in July of 2008. Lacks knowledge or information sufficient to form a belief about the truth of the allegation that he received a phone call from the IRS on September 11, 2008, and for that reason denies it. Denies the remaining allegations.

54. Jeffrey Ogden of Grove City, Ohio was similarly surprised to learn that Elsass could not represent him before the IRS. Ogden paid the FRG Defendants in November 2007 under the up-front contract fee arrangement to prepare amended income tax returns claiming a theft-loss claim of approximately $37,000 for the 2006 tax year, carrying the loss back three years. The IRS disallowed the deduction (stemming from a theft loss relating to a company that was accused of fraud by the SEC), in large part on the grounds that it had been claimed prematurely. Mr. Ogden did not know until the time of his IRS examination in the summer and fall of 2008 that Elsass could not in fact represent him, and has since been attempting to recover the upfront fee he paid to Elsass (and which Elsass purportedly guaranteed would be reimbursed if a deduction was not allowed).

Answer: Lacks knowledge or information sufficient to form a belief about the truth of the allegations regarding Mr. Ogden's state of mind and knowledge, and for that reason denies them. Denies the implication that FRG did not refund Mr. Ogden's fees; it did. Admits the remaining allegations.

55. Elsass has not ceased his false representations in the Forms 2848 he prepares for customers, even after the IRS admonished him in September of 2008 to do so. Indeed, as recently as the beginning of this year, Elsass again filed Forms 2848 in which he represents himself to be an attorney and/or unenrolled preparer despite his indefinitely suspended license.

Answer: Admits that Mr. Elsass filed Forms 2848 in 2010 in which he is identified as an unenrolled preparer. Denies the remaining allegations.

56. In connection with such continual misrepresentation of his authority and status as an attorney, Elsass has also repeatedly pulled a "bait and switch," using proxy representatives to step in for him whenever his customers' theft-loss deductions face an IRS examination. To this end, he has often prepared two Forms 2848 for customers to sign, holding one undated copy in the event of an audit. At that time, the second copy of the Form 2848 will be altered, adding an FRG employee who is a licensed attorney and therefore able to represent the customer before the IRS, and even whiting out or deleting Elsass's name where necessary. In other cases, Elsass simply whites out the name of an attorney representative on a customer's Form 2848 where the individual attorney who had been so designated has left his employment, replacing that name with a new attorney employee. Elsass does this without having the relevant customer execute a new Form 2848.

Answer: Denies.

57. There is no question that Elsass is aware that he falsely represents on his customers' Forms 2848 his status as an attorney or unenrolled preparer. In addition to the September 2008 correspondence the IRS sent to Elsass notifying him that he was not allowed to represent taxpayers before the IRS, the IRS's Small Business/Self-Employed Division also sent correspondence to him in February of 2007 asking him to explain information posted by the Supreme Court of Ohio on its website indicating that (in addition to the indefinite suspension of his attorney license in 1999) his attorney registration had in 2005 also been suspended. Elsass ignored this as well as all subsequent correspondence, and he continues to act in contravention of such notification.

Answer: Denies.

58. On at least 11 documented occasions, Elsass directly obtained from the Government refunds issued to his customers, thereby allowing him to negotiate the refund check, deduct his fee, and then remit the remainder of the refund to a customer. This occurred most commonly where customers elected the "deferred" contract for payment of FRG's fee, and therefore owed nothing for FRG's services until the refund was obtained. In such instances, Elsass instructed the customer to prepare an FMS Form 231, even though the instructions for that form specifically state that "[t]his general power of attorney form should not be used by taxpayers and/or their representatives to authorize the Internal Revenue Service to mail tax refund checks to anyone other than the taxpayer."

Answer: Admits that the instructions for FMS Form 231 state that

"[t]his general power of attorney form should not be used by taxpayers and/or their representatives to authorize the Internal Revenue Service to mail tax refund checks to anyone other than the taxpayer." Denies the remaining allegations.

59. Such conduct specifically violates I.R.C. § 6695(f), which prohibits tax return preparers from endorsing or negotiating "any check made in respect of the taxes imposes by this title which is issued to a taxpayer."

Answer: Denies.

60. Both directly and through advertising, the FRG Defendants informed prospective customers not merely that they might be entitled to a refund from their perceived theft losses, but that a refund was virtually ensured. Elsass himself has repeatedly, but falsely, told customers he had never once "lost" a refund request with the IRS, despite the many occasions in which the IRS disallowed a theft-loss deduction. As a result, the FRG Defendants misled their customers into believing that a refund was almost a sure thing.

Answer: Denies.

61. Elsass's fee structure is also manipulative, and even violates the IRS's tax practitioner guidelines. Circular 230 sets forth the rules for practice before the United States Treasury Department and consists of regulations that appear in Title 31, Part 10, of the Code of Federal Regulations. *See generally* 31 C.F.R. § 10 *et seq.* (2007). "Practice" is defined broadly within Circular 230 and includes the preparation of returns. 31 C.F.R. § 10.2(a)(4). Tax return preparers can be sanctioned by the IRS, and prohibited from continuing to practice before it, for charging a "contingent fee," which is defined in part as "a fee based on a percentage of the refund reported on a return," and/or "any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged . . . or is not sustained." 31 C.F.R. §10.27(b)(2) and (c)(1). Here, given that the whole purpose of the fee arrangement at issue is to maximize the available refund, the FRG Defendants' fee structure openly flouts this practice guideline.

Answer: Paragraph 61 consists of legal arguments, interpretations, and conclusions for which no response is required. Denies the remaining allegations.

62. The FRG Defendants have also repeatedly misrepresented to customers who opted to pay FRG's fee upfront that the fee would be refunded if a theft-loss deduction was disallowed. In fact, the fee was almost never refunded to customers even after the IRS denied a theft-loss claim. Instead, Elsass endlessly fights the IRS on any denied theft-loss claim, no matter how

frivolous or insubstantial the argument against the disallowance, for as long as possible in order to avoid having to issue a fee refund. Upon information and belief, numerous FRG customers have been waiting in excess of one year to be refunded upfront fees paid for FRG's services that did not produce a tax refund. Customers are left waiting and wondering what the status is of their appeal -- and certainly are never informed by the FRG Defendants that the IRS has correctly determined that a theft-loss deduction should be disallowed.

Answer: Denies.

63. The FRG Defendants plainly understand that they have been violating the Internal Revenue Code in promoting improper theft-loss deductions, and in engaging in related wrongful conduct in the service of their promotion efforts. Collectively, the Elsass and the FRG Defendants possess an understanding of how Section 165 actually works. Elsass himself is by training an attorney and holds himself out as possessing experience in the requirements of tax law. Elsass has had repeated exposure to the issues relating to the Section 165 theft-loss deduction, working at two separate companies (including FRG) whose entire business purpose was to promote this deduction to victims of financial fraud. He continues to market his expertise in evaluating Section 165 theft-loss deductions today, as evidenced by FRG's website and national advertisement. Moreover, the materials the FRG Defendants provided to customers to promote their services for the most part accurately described the basic requirements for claiming a Section 165 deduction. Accordingly, all of the FRG Defendants knew, or had reason to know, that they were making false statements to customers with respect to their eligibility for the Section 165 deduction.

Answer: Admits that FRG is familiar and has experience with theft-loss claims under Section 165. Admits that the materials provided by FRG to clients accurately describe the basic requirements for claiming a theft-loss deduction. Denies the remaining allegations and alleges that the government's theory is inconsistent. On the one hand, the government alleges that FRG's expertise in Section 165 is "limited to marketing" and that it has "no expertise at all" in the substance of Section 165. Compl. ¶ 13. On the other, the government alleges that FRG possesses "an understanding of how Section 165 actually works," that Mr. Elsass has had "repeated exposure to the issues relating to the Section 165 theft-loss deduction," and that FRG's materials for clients on Section 165 "for the most part accurately described

the basic requirements for claiming a Section 165 deduction." Compl. ¶ 63.

64. Partial customer lists obtained from FRG indicate that the company had approximately 328 customers as of the end of 2008. The IRS has completed review of the tax returns of 39 such customers where the customer claims an entitlement to a theft-loss deduction, and is presently in the process of reviewing returns from 103 more. But it is already evident, based on the progress of review to date, that the tax revenue lost as a result of improper theft-loss claims engineered by the Defendants is significant.

Answer: Admits that FRG had approximately 328 customers at the end of 2008. Lacks knowledge or information sufficient to form a belief about the truth of the remaining allegations, and for that reason denies them.

65. To date, the IRS has disallowed theft-loss claims resulting in refunds reported by 39 FRG customers in their income tax returns. The potential tax understatement for claiming the theft-loss deduction by these particular customers alone is over $500,000, with an average understatement of $12,912.18 per customer. Simply taking into account the total number of FRG customers whose theft-loss claims are to be examined (142 customers), the projected loss to the Government from false theft-loss claims by the FRG Defendants could be as high as $1.8 million. This figure does not include the thousands of dollars in revenue agent time required to conduct examinations of the FRG Defendants' customers with respect to such theft-loss deduction claims.

Answer: Lacks knowledge or information sufficient to form a belief about the truth of the allegation, and for that reason denies it.

66. The FRG Defendants' extensive involvement in these elaborate tax-fraud schemes over the past several years strongly indicates that the misconduct described in this complaint is likely to recur unless they are permanently enjoined from promotion of this scheme. Indeed, to this day, the FRG Defendants continue to solicit new potential customers through direct mail contact as well as Elsass's personal appearance at seminars and meetings.

Answer: Admits that FRG continues to reach out to victims of financial fraud. Denies the remaining allegations.

67. The United States incorporates by reference the allegations contained in Paragraphs 1 through 66.

Answer: Paragraph 67 is a statement of incorporation for which no response is required. Responds as set forth previously.

68. Section 7407, I.R.C., authorizes a court to enjoin a person from, among other things,

> a. engaging in conduct subject to penalty under I.R.C. § 6694, which penalizes a return preparer who prepares or submits a return or claim that contains a frivolous or unrealistic position, or who willfully attempts to understate a customer's tax liability on a return or claim, or who makes an understatement on a return due to reckless or intentional disregard of rules or regulations;[1] and
>
> B. engaging in any other fraudulent or deceptive conduct that substantially interferes with the proper administration of the internal revenue laws.

Answer: Paragraph 68 consists of legal arguments, interpretations, and conclusions for which no response is required.

69. Tax return preparers are also subject to injunction under I.R.C. § 7407 for engaging in conduct subject to penalty under I.R.C. § 6695, including but not limited to endorsing or negotiating "any check made in respect of the taxes imposes by this title which is issued to a taxpayer." I.R.C. § 6695(f).

Answer: Paragraph 69 consists of legal arguments, interpretations, and conclusions for which no response is required.

70. In addition, preparers may also be enjoined from (a) misrepresenting their eligibility to practice before the IRS and/or experience or education as a tax preparer, or (b) guaranteeing the payment of any tax refund or the allowance of any tax credit. I.R.C. § 7407(b)(1)(B) and (C).

Answer: Paragraph 70 consists of legal arguments, interpretations, and conclusions for which no response is required.

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[1] Section 6694 was amended by the Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28, § 8246, effective for returns prepared after May 25, 2007. Section 6694(a), as amended, subjects a tax return preparer to penalty for understatements of taxpayer liability due to an "unreasonable position," defined as a position where "the tax return preparer knew (or reasonably should have known) of the position," there was no "reasonable belief that the position would more likely than not be sustained on its merits," and "the position was not disclosed as provided in section 6662(d)(2)(B)(ii)" or "there was no reasonable basis for the position." This suit focuses in the main on returns that Elsass and the FRG Defendants prepared prior to May 25, 2007, and accordingly the Government relies on the penalty standards in effect for returns prepared on or before that date. The Government notes, however, that returns prepared by the FRG Defendants since the time of the amendment of Section 6694, which are also part of the basis for this action, would be subject to penalty even under the amended § 6694(a) standards.

71. An injunction is appropriate if any such conduct is demonstrated, and if it appears that injunctive relief is appropriate to prevent recurrence of the conduct. Moreover, if the return preparer's misconduct is continual or repeated, and the court finds that a more narrow injunction (*i.e.,* prohibiting specifically enumerated conduct) would be insufficient to prevent the preparer's interference with the proper administration of federal tax laws, the court may enjoin the person from further acting as a return preparer.

Answer: Paragraph 71 consists of legal arguments, interpretations, and conclusions for which no response is required.

72. The FRG Defendants have continually and repeatedly prepared federal tax returns for their customers setting forth claims for improper, inflated, and/or unsubstantiated deductions based on improperly reported instances of theft loss under Section 165. They have therefore continually and repeatedly submitted returns that assert unrealistic positions and understate their customers' tax liability. Accordingly, they have engaged in conduct subject to penalty under I.R.C. § 6694.

Answer: Denies.

73. The FRG Defendants prepared their customers' tax returns with the knowledge that they were substantially understating the relevant taxpayer's actual tax liability, based upon improperly included and/or unsubstantiated theft-loss deduction claims. They willfully ignored contrary evidence that suggested either that a theft-loss deduction was completely improper, or that it should not be claimed while attempts to recover the allegedly lost amounts were still pending and had the potential to minimize the sum claimed to have been stolen.

Answer: Denies.

74. Elsass has also repeatedly violated Section 6695(f), by negotiating and cashing refund checks issued to his customers.

Answer: Denies.

75. In addition, Elsass has repeatedly and continually falsely represented to his customers and to the IRS, that he is authorized to represent customers before the IRS, whether as an attorney or an unenrolled agent. This conduct is in violation of Section 7407(b)(1)(B). The FRG Defendants have also repeatedly and/or continually guaranteed to their customers that they will receive a theft-loss deduction-based refund.

Answer: Denies.

76. All of the aforementioned conduct of the FRG Defendants, besides violating specifically-enumerated provisions of the Internal Revenue Code, also substantially interferes with the proper administration of the internal revenue laws.

Answer: **Denies.**

77. Given the continual and repeated nature of such violations of these various IRS code provisions, a more narrow injunction would be inadequate to prevent future violations of the federal tax laws by the FRG Defendants. The FRG Defendants should therefore be enjoined from acting as income tax return preparers altogether.

Answer: **Denies.**

78. The United States incorporates by reference the allegations contained in Paragraphs 1 through 77.

Answer: **Paragraph 78 is a statement of incorporation for which no response is required. Responds as set forth previously.**

79. Section 7408 authorizes a court to enjoin persons who have engaged in conduct subject to penalty under I.R.C. §§ 6700 and 6701 from engaging in further such conduct or any other conduct subject to penalty under the Code.

Answer: **Paragraph 79 consists of legal arguments, interpretations, and conclusions for which no response is required.**

80. Section 6700 imposes a civil penalty on any person who organizes or participates in the organization or sale of any plan or arrangement and who makes or furnishes or causes another person to make or furnish a statement with respect to the allowance of a tax deduction or credit that the person knows or has reason to know is false or fraudulent.

Answer: **Paragraph 80 consists of legal arguments, interpretations, and conclusions for which no response is required.**

81. Section 6701 penalizes persons who aid, assist in, procure or advise with respect to the preparation of any portion of a federal tax return, affidavit, claim or other document, when that person knows or has reason to believe that portion will be used in connection with a material matter arising under the federal tax law, and the person knows that the relevant portion will result in the material understatement of the tax liability of another person.

Answer: **Paragraph 81 consists of legal arguments, interpretations, and conclusions for which no response is required.**

82. Here, the FRG Defendants have repeatedly committed violations of Section 6700(a)(1)(B) and (a)(2)(A). The FRG Defendants have actively participated in the sale of their services to investors who believe they have been the victims of investment fraud and theft. They

have done so, moreover, by falsely representing to such investors that theft-loss deductions are available to the customer, when in fact a given customers' losses do not meet the statutory requirements of Section 165, I.R.C, for claiming them as a theft loss. They have also consistently ignored, disregarded or downplayed evidence that might lead them to counsel customers that a theft-loss deduction is not available, or at least cannot be claimed until existing attempts to recover the allegedly stolen sums are resolved.

Answer: **Denies. And, as an affirmative defense, alleges that the government has failed to state a claim upon which relief can be granted under I.R.C. §§ 6700(a)(1)(B) and (a)(2)(A). Section 6700(a)(1)(B) concerns any person who participates directly or indirectly in the sale of an "interest" in an entity or plan or arrangement described in § 6700(a)(1)(A). The government does not allege that FRG sold an interest in an entity, plan, or arrangement. Instead, the government alleges that FRG sold its "services." A sale of such services, however, does not constitute sale of an "interest" within the meaning of Section 6700.**

83. The FRG Defendants also knew or had reason to know that statements they made about the availability of the Section 165 theft-loss deduction to their customers were false or fraudulent, and that these statements were material to the issuance of improper refunds to such customers based on the theft-loss deductions reported in their tax returns. Accordingly, the FRG Defendants have engaged in conduct subject to penalty under Section 6700.

Answer: **Denies. And, as an affirmative defense, alleges that the government has failed to state a claim upon which relief can be granted with respect to § 6700 for the reasons stated in response to paragraph 82 of the complaint.**

84. In addition, the FRG Defendants have engaged in conduct subject to penalty under Section 6701. These FRG Defendants assisted in the generation of documents relating to Section 165 theft-loss claims that were intended to be used, and were used, in connection with material matters arising under the federal tax laws. They collectively provided material assistance to customers claiming these improper and unsubstantiated theft-loss deductions. The FRG Defendants either prepared or assisted in the preparation of numerous documents used in claiming the theft loss, including but not limited to the actual tax forms filed in order to claim the

deductions. And the FRG Defendants provided "back-end" assistance in this process by agreeing to represent customers investigated by the IRS.

Answer: Denies.

85. The FRG Defendants knew or had reason to know that the fraudulent theft-loss claims would be reported on the tax returns prepared for FRG's customers. And given their knowledge of numerous countervailing facts suggesting that the various theft-loss claims they made on behalf of customers were either completely improper or at least premature, they also knew that their conduct would invariably result in the understatement of their customers' tax liability.

Answer: Denies.

86. In light of the above, the FRG Defendants have engaged in conduct subject to penalty under Sections 6700 and 6701. They have done so, moreover, in a continual and/or repeated manner. Unless enjoined by this Court, the Defendants are likely to continue to promote the claiming of improper and fraudulent theft-loss deductions in their customers' tax returns, resulting in further understatements of their customers' tax liability. Indeed, FRG continues to engage in promotion of the theft-loss deduction on a national basis, both through direct mail campaigns and national television advertising. Injunctive relief is therefore appropriate under I.R.C. § 7408.

Answer: Denies.

87. The United States incorporates by reference the allegations contained in paragraphs 1 through 86.

Answer: Paragraph 87 is a statement of incorporation for which no response is required. Responds as set forth previously.

88. Section 7402, I.R.C., authorizes courts to issue injunctions as may be necessary or appropriate for the enforcement of the internal revenue laws. The mandate given to district courts under Section 7402 is broad, and permits courts to enter injunctions even where no specific provision of the Internal Revenue Code has been shown to have been violated.

Answer: Paragraph 88 consists of legal arguments, interpretations, and conclusions for which no response is required.

89. The FRG Defendants, through the actions described above, have engaged in conduct that interferes substantially with the administration and enforcement of the internal revenue laws. The FRG Defendants are representing to customers that they possess expertise regarding Section 165 of the Internal Revenue Code and the proper manner in which a tax payer should claim and substantiate a theft loss. However, rather than impartially analyzing a taxpayer's circumstances

to evaluate whether the taxpayer can legally claim a theft-loss deduction, the FRG Defendants intentionally, or at least with reckless indifference to contrary facts, prepare new or amended tax returns claiming theft-loss deductions for virtually every customer who agrees to pay them a fee. In this respect, the FRG Defendants grossly abuse Section 165 and pervert its true intent, all for the purpose of extracting the greatest amount of fees possible from their customers.

Answer: Denies.

90. As a result, the FRG Defendants have continually and/or repeatedly claimed in the tax returns they prepare improperly-substantiated theft-loss deductions. For many customers, they have falsely characterized mere financial losses as the product of theft. In other cases, the FRG Defendants have improperly claimed a theft-loss deduction for their customers well before it could be ascertained with reasonable certainty that any portion of the loss was unrecoverable, or without regard to whether they have accurately measured the magnitude of the loss. They have done so to maximize the tax benefits of claiming the loss for their clients, and also as a means to generate revenue for FRG. And they have ignored or downplayed evidence of which they were, or should have been, aware suggesting that a theft-loss claim for their customers was inappropriate or untimely. Such conduct has consistently resulted in the understatement of their customers' true tax liability.

Answer: Denies.

91. In addition, Defendant Elsass continues to falsely represent, both to his customers and the IRS, that he is authorized to represent customers before the IRS in connection with any examinations instigated by the very theft-loss deduction claims he urges his customers to make. Such conduct not only misleads customers but causes extra administrative work for the IRS.

Answer: Denies.

92. Elsass also improperly charges fees grossly disproportionate to the value of the services he provides his customers. Those same fees are improperly based on anticipated refunds, encouraging Elsass not to provide his customers sound advice about the availability of a theft-loss deduction, but instead to claim as large a refund for his customers as possible, to ensure he will receive as large a fee as possible. Such conduct encourages the continued filing of improper theft-loss claims, while unjustly enriching Elsass in the process.

Answer: Denies.

93. Given the above, it is evident that the FRG Defendants' conduct results in irreparable harm to the United States for which the United States has no adequate remedy at law. The FRG Defendants' conduct is causing and will continue to cause substantial revenue losses to the United States Treasury, and is also requiring the diversion of substantial IRS resources to investigate.

Answer: Denies.

94. Unless the FRG Defendants are enjoined, the IRS will have to continue to devote manpower and time to resolving improperly substantiated or false theft-loss claims. The burden of pursuing such cases may be an insurmountable obstacle, given the IRS's limited resources. The FRG Defendants will thereupon continue, if not expand, their promotion of claiming theft losses under Section 165 as a means of redress after any taxpayer believes he or she has been the victim of some financial fraud. In so doing, they will continue to engage in conduct that obstructs and interferes with the enforcement of the internal revenue laws. It is in the public interest to enjoin the FRG Defendants' illegal conduct and the harm it causes the United States.

Answer: **Denies.**

PRAYER FOR RELIEF

WHEREFORE, FRG respectfully asks the Court to deny the government's request for a permanent injunction barring FRG from preparing tax returns, deny the government's request for any other relief, dismiss the complaint with prejudice, and award FRG its costs and attorneys' fees.

Respectfully submitted,

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by s/ Christopher S. Rizek per authorization
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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

UNITED STATES OF AMERICA, Plaintiff, v. TOBIAS H. ELSASS, SENSIBLE TAX SERVICES, INC., and FRAUD RECOVERY GROUP, INC., Defendants.	)	No. 2:10cv00336 Judge James L. Graham Magistrate Judge Norah McCann King

CERTIFICATE OF SERVICE

I hereby certify that on May 26, 2010, I electronically filed the foregoing with the Clerk of Court using the CM/ECF system, which will send notification of such filing to all parties.

s/ Christopher S. Rizek
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