United States V. Cruz - Tax Preparers Finally Beat IRS Death Penalty Action

Alexander Smith

Follow this and additional works at: https://repository.law.miami.edu/umlr

Part of the Law Commons

Recommended Citation
Available at: https://repository.law.miami.edu/umlr/vol65/iss4/12

This Note is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.
United States v. Cruz: Tax Preparers Finally Beat IRS Death Penalty Action

ALEXANDER SMITH*

I. INTRODUCTION

Prior to United States v. Cruz,1 courts in the Eleventh Circuit had always sided with the government when it sought to enjoin a person from acting as a tax return preparer2 as a result of the preparer having continuously engaged in offensive conduct.3 Such an injunction is known as a “death penalty” injunction because the enjoined tax return preparer is no longer permitted to perform tax return preparation services.4 Nationally, the government is almost always successful when the issue is litigated.5 The Eleventh Circuit’s decision in Cruz demonstrates that there is a gray area in “death penalty” injunction cases. It will force the government to fully demonstrate that the tax return preparer engaged in an ongoing pattern of fraudulent conduct and that a less restrictive injunction will not be sufficient, before the government will be able to obtain a “death penalty” injunction against a tax return preparer.6 The Eleventh Circuit’s decision can also stand for the broader principle that the IRS will be expected to satisfy the traditional standards for equitable

* Articles and Comments Editor, University of Miami Law Review, J.D./LL.M. in Taxation Candidate 2011, University of Miami School of Law; B.B.A., Emory University. Special thanks to my family for their continued support.

1. 611 F.3d 880 (11th Cir. 2010).
2. Treasury Regulations define “income tax return preparer” broadly so that it includes any individual who receives a fee for playing a significant role in the determination of an item on an income tax return or employs an individual who plays a significant role. Therefore, any attorney or accountant who advises a client with respect to the tax treatment of an item falls within the definition of a tax return preparer. Treas. Reg. § 301.7701-15 (as amended in 2009).
4. See Cruz, 611 F.3d at 883; Pacenti, supra note 3.
5. United States v. Stenline is the only other recent case in which the government failed to obtain a permanent injunction under section 7407(b). In Stenline, the court decided that a fifteen year injunction was sufficient. United States v. Stenline, No. 3:09-CV-2122-L, 2010 WL 423040 (N.D. Tex Feb. 5, 2010).
relief when it seeks an injunction within the Eleventh Circuit.\(^7\)

This note will first discuss the facts and procedural background of the *Cruz* case. Next, it will discuss the District Court's order, followed by the Eleventh Circuit's opinion. Finally, this note will conclude by looking at the implications of the Eleventh Circuit's decision.

II. FACTUAL AND PROCEDURAL BACKGROUND

On July 18, 2007, the IRS sought injunctive relief against Defendants Abelardo Ernest Cruz, Nations Business Center, Inc., Nations Tax Service, Inc., Ruth Real, and Ruth Real and Associates, Inc. under sections 7402(a), 7407, and 7408 of the Internal Revenue Code in the United States District Court for the Southern District of Florida.\(^8\)

Section 7402(a) provides United States District Courts with jurisdiction to issue injunctions and judgments "as may be necessary or appropriate for the enforcement of the internal revenue laws."\(^9\)

Section 7407 gives the district court discretion to enjoin a tax return preparer from engaging in specified prohibited conduct or from acting as a tax return preparer if the court decides that a narrower injunction will be insufficient to prevent the tax return preparer from "interfer[ing] with the proper administration of this title."\(^10\) Section 7407 specifically prohibits a tax return preparer from:

A) engag[ing] in any conduct subject to penalty under sections 6694 or 6695, or subject to any criminal penalty provided by this title; B) misrepresenting his eligibility to practice before the Internal Revenue Service, or otherwise misrepresenting his experience or education as a tax return preparer; C) guarantee[ing] the payment of any tax refund or the allowance of any tax credit; D) engag[ing] in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of Internal Revenue laws.\(^11\)

At the time of the tax return preparations in question, section 6694 prohibited a tax return preparer from both taking an unreasonable position on a tax return and from willfully attempting to understated a taxpayer's tax liability, or from recklessly or intentionally disregarding the tax laws.\(^12\) The relevant part of section 6695 requires a tax return preparer to retain either a copy of each tax return prepared or to maintain a list that

---

7. See *Cruz*, 611 F.3d at 887.
11. 26 I.R.C. § 7407(b) (2010).
12. 26 I.R.C. § 6694 (2004); *Cruz*, 618 F. Supp. 2d at 1387.
includes the name and identification number of each taxpayer.\textsuperscript{13}

Section 7408 provides a district court with discretion to enjoin a tax return preparer from engaging in conduct subject to penalty under sections 6700, 6701, 6707 or 6708 of the Internal Revenue Code or section 330 of title 31 of the United States Code.\textsuperscript{14}

Cruz is a tax return preparer in Miami, Florida, and is the primary manager and operator of Nations Business Center, Inc. and Nations Tax Service, Inc.\textsuperscript{15} In addition to tax return preparation services, Nations Business Center, Inc. and Nations Tax Service, Inc. offered audit representation services to their clients.\textsuperscript{16} Cruz was not permitted to represent taxpayers in audits or appeals.\textsuperscript{17} Real was also a tax return preparer in Miami, Florida.\textsuperscript{18} She was the owner and operator of Ruth Real and Associates, Inc. and also prepared tax returns as an employee of Nations Business Center, Inc. and Nations Tax Service, Inc.\textsuperscript{19} Real was only permitted to represent taxpayers in audits of tax returns that she prepared.\textsuperscript{20}

Cruz first became a target of the IRS around 1995 regarding disallowed fuel credits taken on tax returns prepared by Nations Business Center, Inc.\textsuperscript{21} The IRS revoked Cruz's eligibility to represent taxpayers in audits or appeals in 1998 as a result of incorrectly prepared tax returns.\textsuperscript{22} The current case deals with tax returns prepared by Cruz, Nations Business Center, Inc., Nations Tax Services, Inc., Ruth Real, and Ruth Real and Associates, Inc. for tax years 2003–2006.\textsuperscript{23} Cruz attracted the IRS's attention because the proportion of returns that he prepared that received tax refunds was significantly above the national average.\textsuperscript{24} This was the first time that the IRS took action against the defendants.\textsuperscript{25} Cruz first met with the IRS on this matter in September,

\begin{itemize}
\item \textsuperscript{13} 26 I.R.C. §§ 6695(d), 6107(a) (2010).
\item \textsuperscript{14} 26 I.R.C. § 7408 (2010).
\item \textsuperscript{16} Cruz, 618 F. Supp. 2d at 1384. Nations Business Center does not appear to currently offer audit representation services to their clients. Nations Business Center, http://www.nationsbusinesscenter.com (last visited on March 25, 2011).
\item \textsuperscript{17} Cruz, 618 F. Supp. 2d at 1376.
\item \textsuperscript{18} Id. at 1375.
\item \textsuperscript{19} Id. At 1376.
\item \textsuperscript{20} Id. at 1385.
\item \textsuperscript{21} Id. at 1376.
\item \textsuperscript{22} Id.
\item \textsuperscript{23} Id. at 1377.
\item \textsuperscript{24} Id.
\item \textsuperscript{25} Id. at 1391.
\end{itemize}
At that time, Cruz’s companies lacked quality control procedures. For example, Cruz’s employees, who drafted an initial return upon interviewing the client, did not receive formal tax training or education; tax returns were sometimes prepared without client documentation; and Cruz signed all tax returns as the preparer, even though he did not perform a line-by-line audit of the returns. Following the September, 2004 meeting, however, Cruz instituted quality control procedures. For example, Cruz and his tax preparation employees began attending IRS sponsored courses, Cruz’s employees signed the returns that they prepared as the tax preparer, and the taxpayer was required to initial both an instruction letter and a summary of deductions taken on the return. The rate of errors found in the tax returns audited by the IRS declined in each subsequent year.

III. SOUTHERN DISTRICT OF FLORIDA ORDER

The District Court concluded that an injunction was appropriate under sections 7402(a), 7407(b)(1), and 7408, but that enjoining the defendants from acting as tax return preparers was not warranted.

The court concluded that an injunction was appropriate under section 7407(b)(1) because the defendants prepared tax returns “based on fraudulent deductions and credits” and they misrepresented their eligibility to practice before the IRS. It also determined that an injunction was appropriate under section 7408 because the defendants engaged in conduct subject to penalty under section 6701 for the knowing understatement of another’s tax liability. Further, the court concluded that an injunction was also appropriate under section 7402(a) because an injunction was appropriate under sections 7407 and 7408.

However, the court did not fully agree with the Government’s arguments. First, it disagreed with the Government’s assertion that the average tax loss from the sample of returns that were audited should be extrapolated to all of the returns prepared by defendants. The court also disagreed with the Government’s contention that tax return

26. Id. at 1377.
27. Id. at 1376.
28. Id.
29. Id. at 1386.
30. Id.
31. Id. at 1391.
32. Id.
33. Id. at 1392.
34. Id. at 1388–89.
35. Id. at 1389.
36. Id.
37. Id. at 1390.
preparers should bear responsibility for errors that occur when a tax-
payer does not provide substantiating documentation to the preparer. 
The court stated that "[t]here is no per se liability for a tax return 
preparer whose client is found to have errors on the return when the 
figures appear reasonable on their face. It was and remains the responsi-
bility of the taxpayer to support deductions with documentation if ques-
tioned by the IRS." 38

The court then evaluated the appropriateness of a "death penalty" 
injunction under the Eleventh Circuit’s four-factor test for the issuance 
of permanent injunctions. The test requires that: "1) there has been an 
irreparable injury, 2) damages at law are inadequate, 3) a balance of the 
hardships weighs in favor of the injunction, and 4) the public interest 
would not be disserved by the permanent injunction." 39 First, the court 
concluded that the United States suffered irreparable injury as a result of 
the defendants’ violations of the Internal Revenue Code. 40 Second, it 
concluded that a remedy at law was inadequate because neither "party 
demonstrated that a legal remedy is available to the Government." 41
Next, the court determined that a balance of the hardships weighed par-
tially in favor of an injunction because the defendants "caused losses to 
the United States Treasury by their misstatements on tax returns." 42 On 
the other hand, the defendants’ remedial methods to reduce their errors 
weighed against a "death penalty" injunction. 43 The court further 
pointed out that the IRS waited several years prior to commencing 
action against the defendants. 44 Finally, the court noted that the public 
would be served by a permanent injunction to the extent that it would 
reduce the loss caused by erroneous returns to the United States Trea-
sury. 45 It then stated that conversely, the public would be served by 
available and affordable tax preparation services because few people 
"can competently navigate the intricacies of the Internal Revenue 
Code." 46 The court ultimately held that an injunction against prohibited 
conduct was appropriate rather than a "death penalty" injunction. 47 It 
concluded by stating that if the defendants subsequently engaged in the 
enjoined prohibited conduct, a "death penalty" injunction would be

38. Id.
39. Id. at 1388 (citing Angel Flight of Ga., Inc. v. Angel Flight of Am., Inc., 522 F.3d 1200, 
1208 (11th Cir. 2008)).
40. Id. at 1391.
41. Id.
42. Id.
43. Id. at 1392.
44. Id. at 1391.
45. Id.
46. Id.
47. Id. at 1392.
The Government appealed the District Court’s order to the United States Court of Appeals for the Eleventh Circuit on the ground that the District Court abused its discretion by not issuing a “death penalty” injunction and that it did not require the defendants to provide notice of the injunction to their customers.\textsuperscript{49}

IV. \textbf{ELEVENTH CIRCUIT DECISION}

The Eleventh Circuit, in an opinion authored by Justice O’Connor, ruled that the District Court did not abuse its discretion when it issued an injunction that was narrower than the “death penalty.” The Eleventh Circuit remanded the issue regarding client notification back to the District Court because it did not provide any reasons for its decision on that issue.\textsuperscript{50}

The Government argued that the District Court made three clearly erroneous findings of fact when it declined to issue a “death penalty” injunction. Those three findings of fact were: 1) that the defendants’ conduct was improving; 2) that the improved quality control and tax education procedures would prevent errors in the future; and 3) that a specific-conduct injunction would be sufficient to prevent future violations.\textsuperscript{51}

The Government first argued that the District Court was clearly erroneous to conclude that the defendants’ conduct was improving as a result of a decreasing proportion of returns containing certain errors because the understated tax liability had increased.\textsuperscript{52} The Eleventh Circuit rejected this argument because the relevant inquiry for the District Court was whether the defendants’ violations of section 7407(b)(1) had declined.\textsuperscript{53} Therefore, it was not clearly erroneous for the District Court to look at the rate at which certain errors occurred.

Next, the Government claimed that the District Court was clearly erroneous when it determined that the improved quality control and tax education procedures would prevent future errors because intentional errors cannot be cured by procedural improvements.\textsuperscript{54} Justice O’Connor dismissed the Government’s argument as a misreading of the District Court’s opinion by placing significant weight on the phrases “knew or should have known that they were claiming” and “have knowingly taken

\textsuperscript{48} \textit{Id.}

\textsuperscript{49} United States v. Cruz, 611 F.3d 880, 882 (11th Cir. 2010).

\textsuperscript{50} \textit{Id.}

\textsuperscript{51} \textit{Id.} at 885.

\textsuperscript{52} \textit{Id.} at 886.

\textsuperscript{53} \textit{Id.}

\textsuperscript{54} \textit{Id.}
unreasonable positions on tax returns." Each phrase appeared once in the District Court’s twenty page opinion. Justice O’Connor then concluded that it was logical to find that the defendants’ improved procedures could correct negligent misconduct and that the District Court’s injunction could limit any intentional misconduct.

The Government’s final argument was that the District Court was clearly erroneous when it concluded that a specific-conduct injunction would be sufficient to prevent future violations by the Defendants. It objected to the District Court’s consideration of the traditional equitable factors when it decided on the appropriate level of injunctive relief in this case. The Eleventh Circuit rejected this argument based on the text of section 7407(b)(2) which gives district courts discretion to enjoin persons from acting as tax return preparers. Justice O’Connor focused on Congress’ use of the word “may” in section 7407(b)(2) instead of “shall” or “must.” She further noted that the Eleventh Circuit had previously rejected similar arguments on multiple occasions, including one case that dealt with section 7402(a).

V. IMPLICATIONS OF THE ELEVENTH CIRCUIT’S DECISION

As a result of the Eleventh Circuit’s ruling, it appears that the government will be held to a high standard within the Eleventh Circuit when it seeks a “death penalty” injunction against a tax return preparer under section 7407(b). This case held that improved quality control and tax education procedures may be sufficient for a tax return preparer to avoid a “death penalty” injunction. This is significant because any tax return preparer can take steps to improve quality control and education procedures upon being alerted of an IRS investigation. A tax return preparer’s improved procedures likely must yield significant improvements, as appeared to be the case here. But it is within the tax return preparer’s control.

Cruz demonstrates that there is a gray area in “death penalty” injunction cases, which was not previously apparent based on the government’s one-hundred percent success rate prior to Cruz within the

55. Id.
56. Id.
57. Id.
58. Id. at 887.
59. Id.
60. Id.
61. Id.
62. Id. (citing United States v. Ernst and Whinney, 735 F.2d 1296, 1301 (11th Cir. 1984) (discussing section 7402(a) of the Internal Revenue Code); Klay v. United Healthgroup, Inc., 376 F.3d 1092, 1098 (11th Cir. 2004)).
63. United States v. Cruz, 611 F.3d 880, 887 (11th Cir. 2010).
Eleventh Circuit. Additionally, because the government has an extremely high success rate nationally in "death penalty" injunction cases, *Cruz* will likely play a significant role in future cases. The government will try to distinguish *Cruz* on the grounds that the tax return preparer has done less than the defendants in *Cruz* to demonstrate that a more limited injunction will be sufficient. Conversely, tax return preparers will try to argue that they have done more than the defendants in *Cruz* to demonstrate that a lesser injunction will be sufficient. Ultimately, this case might enable tax return preparers who have made an effort to correct the issues uncovered by the IRS, to negotiate a settlement in which the IRS agrees not to pursue a "death penalty" injunction because they now have a case in which the government was unsuccessful in its pursuit of a "death penalty" injunction.

Additionally, this case explicitly states that the traditional equitable principles will apply within the Eleventh Circuit when a statute gives the district court discretion in deciding whether or not to issue an injunction. Both *Cruz* and *United States v. Ernst and Whinney*\(^{64}\) dealt with provisions of the Internal Revenue Code. Both times, the government’s argument that traditional equitable principles should not have been applied by the district court was rejected. Thus, a tax preparer will be able to make arguments within the framework of traditional equitable principal and, consequently, the government will not be able to convince a district court that traditional equitable principles should not apply.

---

64. *United States v. Ernst and Whinney*, 735 F.2d 1296 (11th Cir. 1984).