IN THE UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA,

Plaintiff,

v.

NICHOLAS P. MAGALHAES,

Defendant.

RECEIVED
U.S. DISTRICT COURT, E.D.N.Y.
IN CLERK'S OFFICE
LONG ISLAND COURTHOUSE
★ MAR 08 2005 ★
ENTERED

CV 05 1251

Civil No.

SEYBERT, J.
J. ORENSTEIN, M.J.

COMPLAINT FOR PERMANENT INJUNCTION

Plaintiff, the United States of America, complains as follows against defendant Nicholas P. Magalhaes:

1. This action has been requested by the Chief Counsel of the Internal Revenue Service, a delegate of the Secretary of the Treasury, and commenced at the direction of a delegate of the Attorney General, pursuant to Internal Revenue Code (I.R.C.) (26 U.S.C.) §§ 7402(a) and 7408.

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

3. Venue is proper in this Court pursuant to 28 U.S.C. § 1391 because the actions complained of occurred within this jurisdictional district.

Magalhaes's Activities

Magalhaes's Plans

4. Defendant Nicholas P. Magalhaes resided at 39 Cambridge Drive, Smithtown, New York and used the mailing address 14 Bond Street, Suite 242, Great Neck, New York for his businesses until October 2004. Since then, Magalhaes has resided at 965 Victoria Terrace, Altamonte Springs, Florida.

5. Through his businesses Asset Accumulation, Inc., Pinnacle Wealth Group, L.L.C., Strategic Ventures, Inc., and Pinnacle Wealth Concepts, Ltd., Magalhaes sells purported voluntary employees' beneficiary association (VEBA) plans to employers that he falsely claims meet the requirements of I.R.C. § 419A(f)(6), which allows employers to make unlimited tax-deductible contributions to qualified welfare benefit plans.

6. Magalhaes's plans enable his customers to pay substantial amounts of deferred compensation to select high-level employees and disguise those payments as employee benefits. This enables the customers to improperly claim income-tax deductions for the compensation and the selected employees to improperly fail to report that compensation as income on their tax returns.

7. Magalhaes promotes various welfare benefit plans, among which are the "America's Multiple Option Exempt Benefit Arrangements (AMOEBA) Program" and the "Wealth Resource Access Plan (WRAP)."

8. Magalhaes sells his plans through his businesses, as well as through independent brokers and accountants.

9. Until mid-2004, Magalhaes promoted his plans on the website www.pinnaclewealth.net.

10. Magalhaes created separate plans, each with its own trust, for different sections of the country and different professional groups. These plans are grouped into the following associations:

- Mid-Atlantic States VEBA Association
- Atlantic States VEBA Association

- South West States VEBA Association
- Rocky Mountain States VEBA Association
- West Coast States VEBA Association

Each association consists of separate plans for each of the following professional groups:

- Medical Professionals
- Building Tradesmen
- Real Estate Professionals
- Merchants
- Manufacturing
- Financial Professionals
- Legal Professionals
- Sports and Entertainment

11. Before December 31, 2000, each plan had an independent bank trustee.

12. As of December 31, 2000, Mid-States Benefits Corporation, a corporation created and controlled by Magalhaes, became the trustee for the plans' trusts.

13. Participating employers sign a trust agreement for a particular plan. For example, a New York construction company signed the trust agreement for the Mid-Atlantic States VEBA Association Building Tradesmen plan.

14. Participating employers contribute to their plan's trust for the purchase of life insurance policies on their employees.

15. For lower-level employees, the plans' trusts purchase term life policies; for select employees, the trusts purchase flexible premium/universal life or whole life policies carrying cash surrender values and special conversion privileges.

16. Employers' contributions to the plan trusts substantially exceed the current-year cost of the insurance policies.

17. Participating employers make larger contributions in the earliest years of participation in order to front-load the expense deduction for tax purposes and to provide cash values in policies for select employees.

18. Although Magalhaes's plans ostensibly provide only death benefits, in reality a participating employer's excess contributions are held by the plan trust to pay the participating employer's future insurance costs and to build cash surrender values for select employees.

19. Magalhaes advises participating employers that they can front-load their plan contributions and deduct the entire amount of those contributions. He also advises that the select employees can defer reporting any income while the excess contributions accumulate tax-free.

20. Magalhaes's plans give select employees conversion privileges allowing them to convert the insurance policies to personal life insurance policies. The conversion occurs automatically if the employee leaves the employer company, the employer misses a payment to the plan trust, or the employer terminates its participation in the plan. In addition, the employee can opt to convert the policy.

21. The conversion privileges enable select employees to withdraw from the plan and own the insurance policy personally. As a result, contributions that the employers previously deducted, and the income the plan trusts generated on those contributions, are never taxed.

22. Magalhaes falsely represents to prospective customers that his plans qualify as tax-exempt VEBAs under I.R.C. § 501(c)(9).

23. Magalhaes also falsely represents that his plans qualify as ten-or-more employer welfare benefit plans under I.R.C. § 419A(f)(6), thus allowing participating employers an unlimited deduction for the full amount of their plan contributions.

24. In his promotional material, Magalhaes makes the following false statements regarding the tax benefits of participation in his plans:

- The plans are VEBAs "supported by I.R.C. Section 419A(f)(6) and Section 501(c)(9)."
- The plans are an "employer sponsored[] employee benefit program, typically funded with life insurance on a tax deductible basis."
- Participating employers may "offset and defer current personal taxable income through employer contributions, which can be tax deductible and flexible."
- Use of the plans can "offset or eliminate a current or future retained earnings problem."
- The full amount of the participating employer's contributions are tax-deductible, and only a small fraction of the contributions are includable in the employees' income.
- Funds in the plans "grow tax-deferred."
- The plans have a favorable letter of determination from the IRS and are "administered in a manner that makes [them] certain to receive continued approval from the IRS."

- "There are virtually no limitations on the amount of the annual contributions that can be made."

25. Some of Magalhaes's plans have fewer than ten participating employers.

26. In some of Magalhaes's plans an individual employer normally contributes more than 10% of the plan's contributions.

27. Magalhaes's plans use experience-rating with respect to the individual employers. Specifically, the plans maintain separate accounts for each employer; each plan's liability to individual participating employers is limited to that employer's contributions; each employer's contributions benefit only its employees and not the employees of other participating employers; the plans do not pool the participating employers' risk because there is no risk—the only benefits are provided through insurance policies.

28. The IRS has identified 107 employers, with an estimated total of 379 employees, that have participated in Magalhaes's plans. These employers and employees are located throughout the United States, including in New York, New Jersey, Texas, Illinois, California, Michigan, Nevada, Oklahoma, Florida, Hawaii, Missouri, North Carolina, Oregon, Utah, Indiana, and Wisconsin.

29. The IRS has determined that from 1996 through 2001 the 107 participating employers it has identified deducted approximately $19.1 million in premiums contributed to Magalhaes's plans. Using an average corporate tax rate of 35%, the IRS estimates that the harm to the United States caused by these improper deductions is approximately $6.7 million, excluding interest. This estimate does not include improper premium deductions claimed before 1996 or after 2001.

30. In addition to the taxes the participating employers evaded by use of Magalhaes's plans, the United States has lost revenue from the select employees who, if they followed Magalhaes's advice, failed to properly report and pay tax on the deferred compensation received through the plans.

31. While independent banks were the trustees for Magalhaes's plan trusts, employers' excess contributions were invested and grew.

32. Once Mid-States Benefits Corporation became the trustee, however, Magalhaes began taking the participating employers' contributions for his personal use and to operate AA and Pinnacle. In addition, he takes unauthorized loans from the cash surrender values of the plan policies without the permission or knowledge of the participating employers or their employees.

33. Magalhaes's books and records show that from 2000 to 2004, as trustee for Mid-States Benefits Corporation he took a total of $4.3 million from the plan trusts and in loans on the plan insurance policies.

34. When the IRS examined an employer participating in his plans, Magalhaes developed an "action plan" for that employer to remove his plan from further IRS scrutiny. Magalhaes's action plan was to have the employer buy all the permanent insurance policies in his plan and restructure the plan so that it would require no immediate or ongoing contributions for several years, thus allowing the plan to "grow old and cold" until the IRS lost interest.

Tax Consequences of Magalhaes's Plans

35. Notwithstanding Magalhaes's representations to the contrary, his plans are not VEBAs, do not meet the requirements of I.R.C. § 419A(f)(6), do not allow unlimited tax-deductible contributions, and are abusive tax plans.

36. I.R.C. § 501(c)(9) defines a VEBA, which is tax-exempt, as "providing for the payment of life, sick, accident, or other benefits to the members of such association" if "no part of the net earnings of [the VEBA] inures (other than through such payments) to the benefit of any private shareholder or individual."

37. "Other benefits" that a VEBA may provide to employees are limited to benefits that are similar to life, sick, or accident benefits; a VEBA may not provide deferred compensation or other benefits that become payable by reason of the passage of time rather than as a result of an unanticipated event.

38. Magalhaes's plans do not meet the definition of a VEBA under I.R.C. § 501(c)(9) because they provide deferred compensation and because a portion of their earnings, in the form of the insurance policies' cash surrender value and the plans' conversion privileges, inures to the benefit of select employees.

39. Because Magalhaes's plans are not VEBAs, their income is not tax-exempt.

40. I.R.C. §§ 419 and 419A limit the amount an employer may deduct for contributions to a welfare benefit fund—which provides employees welfare benefits such as sickness, accident, hospitalization, medical expense, or similar benefits—to the fund's qualified cost for the year.

41. As an exception to the general rule of I.R.C. §§ 419 and 419A limiting an employer's deductible contributions to a welfare benefit fund, I.R.C. § 419A(f)(6) permits employers to deduct unlimited contributions if the fund meets the following requirements:

- the fund must be an arrangement of ten or more employers who pool their resources as opposed to a group of individual plans with separate accounting for each employer;

- no participating employer may normally contribute more than 10% of the total fund contributions; and
- the fund may not maintain experience-rating arrangements with respect to individual employers.

42. Magalhaes's plans do not meet the requirements of I.R.C. § 419A(f)(6) because (a) some of the plans have fewer than ten employers; (b) in some of the plans an individual employer normally contributes more than 10% of the plan's contributions; and (c) the plans use experience-rating with respect to the individual employers.

43. Because Magalhaes's plans do not meet the requirements of I.R.C. § 419A(f)(6), employer contributions beyond the current year cost of insurance are not deductible.

44. Pursuant to I.R.C. § 404(a)(5), an employer may deduct contributions to a non-qualified deferred compensation plan only in the year in which the contribution is included in the gross income of the employees participating in the plan and only if the plan maintains separate accounts for each employee.

45. Excess contributions to Magalhaes's plans are not deductible as deferred compensation under I.R.C. § 404(a)(5) because they are not includable in the employees' income in the same year that the employer claims a deduction.

46. I.R.C. § 162(a) allows employers to deduct ordinary and necessary business expenses.

47. Excess contributions to Magalhaes's plans are not deductible as business expenses under I.R.C. § 162(a) because they are neither ordinary nor necessary.

48. Magalhaes's plans are abusive tax shelters because Magalhaes improperly advises participating employers to claim deductions for their excess contributions and defer or not report the corresponding amount in the employees' gross income.

49. Magalhaes has admitted to the IRS that the purpose of his plans is tax avoidance.

50. Magalhaes knows or has reason to know his plans do not give the tax advantages he advertises for the following reasons:

- The "action plan" he drafted for a participating employer under IRS examination states that the IRS is likely to prevail in disallowing the deductions the employer claimed for contributions to the plan.
- IRS Notice 95-34, Tax Problems Raised by Certain Trust Arrangement Seeking to Qualify for Exemption from Section 419, explains that plans such as Magalhaes's do not qualify as ten-or-more employer plans under I.R.C. § 419A(f)(6).
- Courts have ruled that similar plans do not qualify under I.R.C. § 419A(f)(6). *See Neonatology Assocs. v. Commissioner*, 115 T.C. 43 (2000), *aff'd* 299 F.3d 221 (3d Cir. 2002); *Booth v. Commissioner*, 108 T.C. 524 (1997).

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

51. The United States incorporates by reference the allegations in paragraphs 1-50.

52. I.R.C. § 7408 authorizes a district court to enjoin any person from, *inter alia*, engaging in conduct subject to penalty under either I.R.C. §§ 6700, 6701, 6707, or 6708 if injunctive relief is appropriate to prevent recurrence of that conduct.

53. I.R.C. § 6700 penalizes any person who organizes or sells a plan or arrangement and, in connection with the organization or sale, makes a statement regarding any tax benefit which the person knows or has reason to know is false or fraudulent as to any material matter.

54. Magalhaes organizes, promotes, and sells plans that he falsely claims qualify as VEBAs and ten-or-more employer welfare benefit plans under I.R.C. § 419A(f)(6) such that participating employers can take large deductions from their federal tax returns and avoid taxation on deferred compensation to their select employees.

55. In organizing and selling his plans, Magalhaes makes false or fraudulent statements regarding the excludibility of income and other tax benefits.

56. Magalhaes knows or has reason to know that his promotional materials contain false or fraudulent statements within the meaning of I.R.C. § 6700.

57. If he is not enjoined, Magalhaes is likely to continue to organize and sell his abusive tax plans.

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

Count II
Injunction under I.R.C. § 7402(a)
and the Appropriateness of Injunctive Relief

59. The United States incorporates by reference the allegations in paragraphs 1 through 58.

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

61. Magalhaes substantially interferes with the enforcement of the internal revenue laws by devising abusive tax plans that he falsely advises employers allow them to claim large tax deductions while passing income, untaxed, to select employees.

62. By drafting an "action plan" to attempt to remove his plans from IRS scrutiny, Magalhaes has engaged in conduct that obstructs and interferes substantially with the enforcement of the internal revenue laws.

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

64. The United States is harmed by Magalhaes's abusive tax plans because participating employers take large deductions to which they are not entitled and their employees improperly fail to report income they have received.

65. The United States is harmed by Magalhaes's interference with IRS examinations because it impedes the IRS's discovery and recovery of unreported and unpaid taxes.

66. In addition, the United States is harmed because the IRS is forced to devote its limited resources to identifying and recovering this lost revenue from Magalhaes's customers.

67. The United States will suffer irreparable harm if Magalhaes is not enjoined because the tax loss he causes with his plans will continue to accumulate and may prove unrecoverable, and because the IRS will have to continue to devote resources to assessing and collecting his customers' taxes.

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

69. The public interest will be advanced by enjoining Magalhaes because an injunction will stop his illegal conduct and the harm it is causing.

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

A. That the Court find that Magalhaes has engaged in conduct subject to penalty under I.R.C. § 6700 and that injunctive relief under I.R.C. § 7408 is necessary and appropriate to prevent recurrence of that conduct;

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

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

1. Organizing, promoting, marketing, or selling any tax plan, shelter, or arrangement that advises, encourages, or assists taxpayers to attempt to violate the internal revenue laws or unlawfully evade the assessment or collection of their federal tax liabilities;

2. Making false statements about the allowability of any deduction or credit, the excludability of any income, or the securing of any tax benefit by the reason of participating in any tax plan, shelter, or arrangement;

3. Organizing or selling tax shelters, plans, or arrangements that falsely purport to qualify as VEBAs under I.R.C. § 501(c)(9) or as ten-or-more employer welfare benefit plans under I.R.C. § 419A(f)(6);

4. Receiving fees, commissions, or other compensation from any purported VEBA or ten-or-more employer welfare benefit plan;

5. Engaging in any other activity subject to penalty under I.R.C. § 6700;

6. Advising or assisting anyone to attempt to conceal activities from the IRS or obstruct IRS investigations; and

7. Engaging in other conduct that substantially interferes with the proper administration and enforcement of the internal revenue laws;

D. That the Court, pursuant to I.R.C. §§ 7402(a) and Treasury Regulation (26 C.F.R.) § 301.6112-1, order Magalhaes to produce to counsel for the United States a list of the employers and other persons participating in his tax plans and any records in his possession or to which he has access identifying by name, taxpayer-identification number, address, e-mail address, and telephone number all individuals and entities who participated in his plans or who sold or brokered his plans to others;

E. That the Court order Magalhaes to complete the requirements listed in paragraph D within 11 days of the Court's order and order Magalhaes to file with the Court a certificate of compliance with those requirements, along with evidence of compliance, within 12 days of the Court's order;

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

G. That the United States be entitled to conduct discovery for the purpose of monitoring Magalhaes's compliance with the terms of any permanent injunction entered against him; and

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

Respectfully submitted,

ROSLYNN MAUSKOPF
United States Attorney

ANNE NORRIS GRAHAM (AG8213)
Trial Attorney, Tax Division
U.S. Department of Justice
Post Office Box 7238
Washington, D.C. 20044
Tel.: (202) 353-4384
Fax: (202) 514-6770