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UNITED STATES DISTRICT COURT
DISTRICT OF IDAHO

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ALAN PESKY and WENDY PESKY,
Plaintiffs,
v.
UNITED STATES OF AMERICA,
Defendant.

NO. CIV. 1:10-186 WBS
MEMORANDUM AND ORDER RE:
MOTION TO DISMISS

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Plaintiffs Alan and Wendy Pesky brought suit against the United States of America seeking a refund for taxes, penalties, and interest assessed against them for the 2003 and 2004 tax years. After a stay of the action and the filing of the First Amended Complaint, the United States filed counterclaims against the Peskys. The Peskys now seek to dismiss the United States' counterclaims for civil fraud penalties due to conservation easement fraud and Schedule C expense fraud pursuant to Federal Rule of Civil Procedure 12(b)(6).

I. Factual and Procedural Background

1 Alan and Wendy Pesky are husband and wife. The Peskys
2 brought suit against the United States in April 2010 seeking
3 recovery of taxes, penalties, and interest assessed by the United
4 States for the 2003 and 2004 tax years. (Docket No. 1.) The
5 Peskys then moved for partial summary judgment against the United
6 States, but the motion was denied. (Docket No. 54.) On
7 September 20, 2011, the United States moved to stay the action
8 under 26 U.S.C. § 7422(e) because the Internal Revenue Service
9 ("I.R.S.") issued new statutory notices of deficiency against the
10 Peskys for the 2003 and 2004 tax years. (United States' Mot. to
11 Stay (Docket No. 58).) The new notices of deficiency included
12 adjustments to income and expenses as to both Alan and Wendy
13 Pesky, but the notice to Alan Pesky included a civil fraud
14 penalty under 26 U.S.C. § 6663 and additions to tax pursuant to §
15 6662. (Id. at 2, Ex. B.) The I.R.S. also allegedly issued a
16 statutory notice of deficiency against the Peskys for the 2002
17 tax year. (Id. at 2; FAC ¶¶ 15-19.)

18 The court stayed the action pursuant to 26 U.S.C. §
19 7422(e) on October 13, 2011. (Docket No. 61.) After an oral
20 request by the parties during a telephonic status conference on
21 September 17, 2012, the court lifted the stay. (Docket No. 71.)
22 The Peskys filed their First Amended Complaint on September 24,
23 2012.¹ (Docket No. 72.) The United States filed its Answer to
24

25 ¹ The Peskys appear to have declined to file a petition
26 for redetermination in the Tax Court within the statutory period,
27 thus giving the United States the option of filing a
28 counterclaim. See 26 U.S.C. § 7422(e) ("If the Secretary prior
to the hearing of a suit brought by a taxpayer in a district
court . . . mails to the taxpayer a notice that a deficiency has
been determined in respect of the tax which is the subject matter

1 the First Amended Complaint and its Counterclaim against the
2 Peskys on October 9, 2012. (Docket No. 74.)

3 The Counterclaim alleges that, in 1993, Alan Pesky
4 began negotiations to acquire a piece of undeveloped property in
5 Blaine County, Idaho ("Ketchum Property"). (Countercl. ¶¶ 13-
6 14.) The Ketchum Property is adjacent to another property where
7 Ernest Hemingway's last home stood ("Hemingway Property"). (Id.
8 ¶ 6.) Mary Hemingway is alleged to have granted an easement to
9 the owners of the Ketchum Property in 1985 ("Hemingway
10 Easement"), though the easement was arguably legally defective.
11 (Id.) Upon Mrs. Hemingway's death, The Nature Conservancy
12 ("TNC") allegedly became the owner of the Hemingway Property and
13 disputed the Ketchum Property owners' right to access the Ketchum
14 Property via the Hemingway Easement. (Id. ¶¶ 7-8.)

15 Paul MacCaskill and John Hagestad ("M&H"), the owners
16 of the Ketchum Property at the time, allegedly sued TNC to reform
17 the Hemingway Easement and obtain access to the Ketchum Property.
18 (Id. ¶ 12.) TNC allegedly responded to the lawsuit by purchasing
19 an option to buy the Ketchum property. (Id. ¶ 15.)

20 The United States alleges that Alan Pesky, through his
21 attorney, negotiated and eventually engaged in a transaction with
22 TNC whereby the Peskys would receive the option to buy the
23 Ketchum Property and a perfected easement for a driveway over the

24
25 of taxpayer's suit, the proceedings in taxpayer's suit shall be
26 stayed If the taxpayer files a petition with the Tax
27 Court, the district court . . . shall lose jurisdiction of the
28 taxpayer's suit to whatever extent jurisdiction is acquired by
the Tax Court If the taxpayer does not file a petition
with the Tax Court for a redetermination of the asserted
deficiency, the United States may counterclaim in the taxpayer's
suit").

1 Hemingway Property. (Id. ¶¶ 15-36.) In exchange, Alan Pesky is
2 alleged to have given TNC payment as well as a conservation
3 easement that limited development of the Ketchum Property to a
4 single home and related buildings. (Id.)

5 The United States further alleges that Mr. Pesky
6 attempted to structure the transaction to hide its quid pro quo
7 nature so that he could claim a charitable deduction based on the
8 conservation easement. (Id. ¶¶ 27-30.) Specifically, the United
9 States alleges that the negotiations were for a single
10 transaction, but that the transaction was broken up into separate
11 documents. (Id. ¶ 20.) In the Assignment Agreement, in exchange
12 for \$50,000 and the Peskys' agreement to limit the height of any
13 structures on the property ("Easement Agreement"), TNC allegedly
14 agreed to grant the Peskys the option to purchase the Ketchum
15 Property from M&H and agreed to support Mr. Pesky's application
16 for driveway approval with the local authorities ("Driveway
17 Easement"). (Id. Exs. 20, 22-24.) In a separate document called
18 the Pledge Agreement, Mr. Pesky agreed to pay \$400,000 to TNC and
19 convey within five years "all right to develop or improve the
20 [Ketchum] Property except for one single-family residence and
21 such accessory buildings as are allowed under applicable zoning."
22 (Id. ¶ 31, Exs. 21, 25.)²

23 Mr. Pesky is alleged to have consulted an accounting
24 firm as early as February 1993 to discuss the effective profit he
25 would make by selling the Ketchum Property once the charitable
26

27 ² The Pledge Agreement was allegedly secured by a
28 liquidated damages clause and by Alan Pesky granting deeds of
trust to TNC. (Countercl. ¶¶ 31, 35, Exs. 25, 26.)

1 deduction for the conservation easement was factored in. (Id. ¶
2 38.) The United States also alleges that, at Mr. Pesky's
3 insistence, the Pledge Agreement was never recorded, (id. ¶ 33),
4 and that Mr. Pesky attempted to keep the Pledge Agreement secret
5 from outside parties, including city officials and even
6 appraisers of the property. (Id. ¶¶ 30-34, 56-63, 66, 105-10,
7 Exs. 35-36, 39, 67-71.)

8 Mr. Pesky allegedly exercised his option to purchase
9 the Ketchum Property for \$1.6 million, (id. ¶ 36, Exs. 6, 27),
10 and TNC is alleged to have granted Mr. Pesky an Amended Driveway
11 Easement, (id. ¶ 50, Ex. 34). Mr. Pesky is alleged to have begun
12 marketing the property soon after obtaining the Amended Driveway
13 Easement and eventually sold the property for around \$7 million,
14 (id. ¶¶ 65, 97, Ex. 61). After extending the time to comply with
15 the Pledge Agreement, (id. ¶¶ 70, 76, Exs. 41, 45), Mr. Pesky
16 allegedly complied with the terms of the Pledge Agreement by
17 granting a conservation easement to TNC in March 2002, just days
18 before selling the property, (id. ¶ 96, Ex. 60).

19 Mr. Pesky allegedly reported a charitable deduction of
20 \$3 million--the appraised value of the conservation easement--on
21 his 2002, 2003, and 2004 tax returns. (Id. ¶¶ 112, Ex. 74.)
22 When the I.R.S. began an audit of Mr. Pesky's tax deductions, he
23 is alleged to have withheld responsive documents, including the
24 Pledge Agreement. (Id. ¶¶ 113-31.)³

25
26 ³ The scope of the I.R.S.'s investigation was hotly
27 contested and led to multiple petitions in this court. See Pesky
28 v. United States, Civ. No. 1:10-06789 E JL CWD (Dist. Idaho 2010)
(Pesky's petition to quash an I.R.S. summons); United States v.
Pesky, Civ. No. 1:10-00143 E JL (Dist. Idaho 2010) (United States'

1 On the basis of these facts, the United States brings
2 four counterclaims: (1) conservation easement fraud under 26
3 U.S.C. § 6663 against Mr. Pesky; (2) Schedule C expense fraud
4 under § 6663 against Mr. Pesky; (3) penalties for failure to file
5 within the time proscribed by law against both Mr. and Mrs.
6 Pesky; and (4) failure to pay assessed amounts under § 6663 or,
7 alternatively, § 6662 against both Mr. and Mrs. Pesky. (Id. ¶¶
8 149-79.) The Peskys now move to dismiss the first and second
9 counterclaims under Federal Rule of Civil Procedure 12(b)(6) for
10 failure to state a claim upon which relief can be granted.

11 II. Discussion

12 To survive a motion to dismiss, a claimant must plead
13 "only enough facts to state a claim to relief that is plausible
14 on its face." Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570
15 (2007). This "plausibility standard," however, "asks for more
16 than a sheer possibility that a defendant has acted unlawfully,"
17 Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009), and "[w]here a
18 complaint pleads facts that are 'merely consistent with' a
19 defendant's liability, it 'stops short of the line between
20 possibility and plausibility of entitlement to relief.'" Id.
21 (quoting Twombly, 550 U.S. at 557). In deciding whether a

22 _____
23 petition to enforce an I.R.S. summons); United States v. Richey,
24 Civ. No. 1:08-00452 EJM (Dist. Idaho 2008) (United States'
25 petition to enforce an I.R.S. summons), consolidated with Civ.
26 No. 1:08-10-00143. In one of the suits, the Ninth Circuit
27 overturned the district court's holding that the entire work file
28 of Mark Richey, the appraiser of the conservation easement, was
protected by the attorney-client privilege and by the work-
product doctrine, thus remanding the case back to the district
court for an in camera examination of the materials summoned by
the I.R.S. in order to determine which documents, if any, were
protected from disclosure. United States v. Richey, 632 F.3d
559, 566-68 (9th Cir. 2011).

1 claimant has stated a claim, the court must accept the
2 allegations in the complaint as true and draw all reasonable
3 inferences in favor of the claimant. Scheuer v. Rhodes, 416 U.S.
4 232, 236 (1974), overruled on other grounds by Davis v. Scherer,
5 468 U.S. 183 (1984); Cruz v. Beto, 405 U.S. 319, 322 (1972).

6 A. Civil Fraud Penalty under § 6663

7 Section 6663 provides that “[i]f any part of any
8 underpayment of tax required to be shown on a return is due to
9 fraud, there shall be added to the tax an amount equal to 75
10 percent of the portion of the underpayment which is attributable
11 to fraud.” 26 U.S.C. § 6663(a).

12 In the context of the seventy-five percent penalty of §
13 6663,⁴ “fraud is intentional wrongdoing on the part of the
14 taxpayer with the specific intent to avoid a tax known to be
15 owing.” Bradford v. Comm’r, 796 F.2d 303, 307 (9th Cir. 1986)
16 (quoting Akland v. Comm’r, 767 F.2d 618, 621 (9th Cir. 1985)).
17 To establish liability for the civil fraud penalty, “the
18 Government must establish: (1) a knowing falsehood; (2) an intent
19 to evade taxes; and (3) an underpayment of tax.” Considine v.
20 United States, 683 F.2d 1285, 1286 (9th Cir. 1982).

21 The government “must prove fraud by clear and
22 convincing evidence, but intent can be inferred from strong
23 circumstantial evidence.” Bradford, 796 F.2d at 307 (quoting

24
25 ⁴ The Tax Reform Act of 1986, Pub. L. No. 99-514, 100
26 Stat. 2085 (1986), amended 26 U.S.C. § 6653(b) to increase the
27 civil penalty for fraud from fifty percent to seventy-five
28 percent. Cooley v. Comm’r, 87 T.C.M. (CCH) 1025, 2004 WL 406756,
at *7 n.4 (2004). The Omnibus Budget Reconciliation Act of 1989,
Pub. L. No. 101-239, 103 Stat. 2106 (1989), subsequently removed
the civil penalty for fraud from § 6653(b) and replaced it with §
6663. Id.

1 Akland, 767 F.2d at 621 (internal citations omitted)); see 26
2 U.S.C. § 7454(a) ("In any proceeding involving whether the
3 petitioner has been guilty of fraud with intent to evade tax, the
4 burden of proof in respect to such issue shall be upon the
5 Secretary."). "Because fraudulent intent is rarely established
6 by direct evidence, this court has inferred intent from various
7 kinds of circumstantial evidence. These 'badges of fraud'
8 include: (1) understatement of income; (2) inadequate records;
9 (3) failure to file tax returns; (4) implausible or inconsistent
10 explanations of behavior; (5) concealing assets; and (6) failure
11 to cooperate with tax authorities." Id. (internal citations
12 omitted).

13 1. Conservation Easement Fraud

14 "Section 170(a) of the Internal Revenue Code of 1954
15 allows a deduction for charitable contributions" Collman
16 v. Comm'r, 511 F.2d 1263, 1266 (9th Cir. 1975); see 26 U.S.C. §
17 170(a). "A charitable contribution is a gift of property to a
18 charitable organization, made with charitable intent and without
19 the receipt or expectation of receipt of adequate consideration."
20 Mitchell v. Comm'r, 138 T.C. No. 16, 2012 WL 1109342, at *4
21 (2012) (citing Hernandez v. Comm'r, 490 U.S. 680, 690 (1989);
22 United States v. Am. Bar. Endowment, 477 U.S. 105, 116-18; 26
23 C.F.R. § 170A-1(h)(1)-(2)). "While a taxpayer is generally not
24 allowed a charitable deduction for a gift of property consisting
25 of less than an entire estate in that property, an exception is
26 made for a 'qualified conservation contribution.'" Id.; see 26
27 U.S.C. § 170(f)(3)(A), (f)(3)(B)(iii), (h).

28 Here, the United States alleges that Alan Pesky

1 underpaid his taxes by fraudulently deducting the full value of a
2 conservation easement as a charitable deduction when the easement
3 was obtained through a quid pro quo transaction with TNC.
4 (Countercl. ¶¶ 151-53.) The court has examined over ninety
5 exhibits that the United States attaches in support of its
6 counterclaims. See generally United States v. Corinthian
7 Colleges, 655 F.3d 984, 999 (9th Cir. 2011) (noting that a court
8 may “consider materials that are submitted with and attached to
9 the Complaint” on a Rule 12(b)(6) motion to dismiss). In its
10 counterclaims and attached exhibits, the United States identifies
11 key documents and communications between the various people
12 alleged to have participated in or been affected by the fraud.

13 For example, in support of its allegations that the
14 Assignment Agreement and Pledge Agreement were part of a single
15 transaction, the United States attaches internal memoranda shared
16 with Mr. Pesky that detail the negotiations between TNC and the
17 Peskys’ attorneys. (See id. Exs. 10-16.) The memoranda note
18 that both the Assignment Agreement and Pledge Agreement were
19 drafted around the same time, (id. Ex. 10), discuss the terms of
20 the Assignment Agreement and the Pledge Agreement in the same
21 memoranda, (id. Ex. 11), as well as have a subject line that
22 refers to the “Nature Conservancy Transaction” in the singular,
23 (id. Exs. 11, 13). The Pledge Agreement notes that it “arises
24 out of” and is “integral with” the Assignment Agreement, (id. Ex.
25 25), and the minutes from a zoning board meeting include a
26 statement from Mark Elsbree, a TNC employee, that TNC “had agreed

1 to grant Mr. Pesky a reformed easement,⁵ conditioned upon the
2 fact that he can build one house (and one guest house) there,"
3 (id. ¶ 46, Ex. 32).

4 The United States also includes specific factual
5 allegations and exhibits regarding Mr. Pesky's intent to defraud,
6 such as attempts to keep the Pledge Agreement hidden from city
7 officials, real estate agents, and appraisers, (id. ¶¶ 57-63, 66,
8 105-09, Exs. 35-36, 39, 67-71), as well as his refusal, through
9 his attorney, to share the Pledge Agreement and other documents
10 with the I.R.S., (id. 116-47, Exs. 76-95). When questioned on
11 the subject, Mr. Pesky is alleged to have claimed a near total
12 lack of recall as to anything related to the Pledge Agreement.
13 (Id. ¶ 148.)

14 The Peskys argue - and the United States does not
15 contest - that the heightened pleading standard of Federal Rule
16 of Civil Procedure 9(b) applies to the United States'
17 counterclaims for fraud under § 6663. See Vess v. Ciba-Geigy
18 Corp., USA, 317 F.3d 1097, 1106 (9th Cir. 2003) (stating that
19 averments of fraud must be "specific enough to give defendants
20 notice of the particular misconduct so that they can defend
21 against the charge and not just deny that they have done anything
22 wrong" (internal quotation marks and citations omitted)); Gaughen
23 v. United States, Civ. No. 1:09-2488, 2011 WL 292019, at *2-3
24 (M.D. Penn. Jan. 27, 2011) (applying Rule 9(b) to the
25 government's answer in a suit by a taxpayer seeking a Rule 12(c)

27 ⁵ The "reformed easement" here could reasonably be
28 interpreted as referring to the Driveway Easement contained in
the Assignment Agreement.

1 judgment on the pleadings for a refund of § 6663 penalties). But
2 see Payne v. United States, 247 F.2d 481, 485 (8th Cir. 1957)
3 (“We should doubt that [Rule 9(b)] has any application to a
4 complaint in a suit to collect assessed tax deficiencies and
5 fraud penalties, of which the taxpayer has administratively been
6 given due notice of determination, assessment, and demand for
7 payment.”).

8 Assuming, arguendo, that the heightened pleading
9 requirements of Rule 9(b) apply to the United States’
10 counterclaims for civil fraud penalties under § 6663, the United
11 States has more than adequately pled facts of particular
12 misconduct regarding the allegedly fraudulent charitable
13 deduction so that the Peskys can adequately defend against the
14 charge. See Vess, 317 F.3d at 1106.

15 The Peskys argue that the United States’ allegations
16 misconstrue the nature of the transactions at issue and that a
17 close reading of the exhibits forecloses any plausible
18 possibility of fraud by Mr. Pesky. While the court “‘need not
19 accept the allegations as being true’” when “material is attached
20 to the complaint which refutes the allegations contained in the
21 complaint,” Hores v. Mason, 1999 WL 674588, at *4 (Dist. Idaho
22 July 19, 1999) (quoting Roth v. Garcia Marquez, 942 F.2d 617, 625
23 (9th Cir. 1991)), the Peskys ask the court to go far beyond this
24 rule and adopt their interpretation of the documents. Such an
25 approach is inappropriate in ruling on a Rule 12(b)(6) motion
26 since the court must draw all reasonable inferences in favor of
27 the claimant. Scheuer, 416 U.S. at 236, overruled on other
28 grounds by Davis, 468 U.S. at 191.

1 For example, the Peskys argue that exhibits documenting
2 the negotiations show that the Peskys and TNC never negotiated
3 for a one home site restriction in exchange for the option to buy
4 the Ketchum Property, but instead only contemplated a three home
5 site restriction. (See Countercl. Exs. 5, 8, 9.) However, the
6 fact that the attached exhibits may show that the Peskys and TNC
7 discussed alternative arrangements is not inconsistent with the
8 United States' allegations. The fact that the Peskys and TNC may
9 have discussed alternatives during their negotiations does not
10 preclude the inference that they eventually settled upon a one
11 home site restriction as part of the exchange for the option to
12 buy the Ketchum property.

13 Accepting as true all material allegations in the
14 counterclaims and drawing all reasonable inferences in favor of
15 the United States, the United States has adequately pled a
16 counterclaim for a civil penalty under § 6663 based on the
17 Pesky's allegedly fraudulent charitable deduction for the value
18 of the conservation easement. Thus, the court will not dismiss
19 the United States' first counterclaim.

20 2. Schedule C Fraud

21 "In general, section 162 allows deductions for ordinary
22 and necessary expenses of carrying on a trade or business."
23 Shelton v. Comm'r, 72 T.C.M. (CCH) 807, 1996 WL 544608, at *4
24 (1996); 26 U.S.C. § 162(a). "As used in section 162(a),
25 'ordinary' has been defined as that which is 'normal, usual, or
26 customary' in the taxpayer's trade or business." Id. (citing
27 Deputy v. DuPont, 308 U.S. 488, 495 (1940)). "'Necessary' has
28 been construed to mean 'appropriate' or 'helpful' in the

1 development of the taxpayer's business." Id. (citing Welch v.
2 Helvering, 290 U.S. 111, 113 (1933)). "Unless expressly provided
3 for, section 162 prohibits deductions for personal, living, or
4 family expenses." Id. In an action to impose the civil penalty
5 of § 6663, "fraudulent understatement of income may be
6 established by overstatement of Schedule C expenses." Cooley v.
7 Comm'r, 87 T.C.M. (CCH) 1025, 2004 WL 406756, at *8 (2004)
8 (citations omitted).

9 In stark contrast to its allegations regarding the
10 conservation easement deduction, the United States' pleadings are
11 conspicuously devoid of factual allegations regarding fraudulent
12 business deductions on the Peskys' Schedule C forms. The
13 Counterclaim includes formulaic allegations of liability under §
14 6663, (Countcl. ¶ 158), and alleges that Alan Pesky wrongly
15 "claimed expenses incurred by himself personally or by entities
16 other than any of his possible sole proprietorships as ordinary
17 and necessary expenses," including "as a non-exhaustive
18 example[,] . . . expenses for accounting services." (Id. ¶¶ 159-
19 60.) The United States alleges that Mr. Pesky never operated a
20 sole proprietorship that incurred the Schedule C expenses on his
21 2003 and 2004 tax returns, yet it asserts no factual allegations
22 related to the Schedule C expenses, such as what "possible sole
23 proprietorships" and entities are alleged to have be involved,
24 what expenses were deducted, or what facts lead the United States
25 to believe that Mr. Pesky did not operate a sole proprietorship.
26 The United States has not included enough factual allegations to
27 "nudge[] [its] claim[] across the line from conceivable to
28

1 plausible." Twombly, 550 U.S. at 547.⁶

2 Thus the court will dismiss the United States'
3 counterclaim for civil penalties under § 6663 due to Mr. Pesky's
4 allegedly fraudulent reporting of business expenses on his
5 Schedule C forms.

6 Since this is the first motion to dismiss the United
7 States' counterclaims, and the United States appears to be able
8 to cure the deficiency, it will be granted leave to amend. See
9 Foman v. Davis, 371 U.S. 178, 182 (1962) ("In the absence of any
10 apparent or declared reason--such as undue delay, bad faith or
11 dilatory motive on the part of the movant, repeated failure to
12 cure deficiencies by amendments previously allowed, undue
13 prejudice to the opposing party by virtue of allowance of the
14 amendment, futility of amendment, etc.--the leave sought should,
15 as the rules require, be 'freely given.');

16 IT IS THEREFORE ORDERED that the Peskys' motion to
17 dismiss be, and the same hereby is:

18 (1) DENIED as to the United States' first counterclaim
19 for a civil fraud penalty under 26 U.S.C. § 6663 due to Alan
20 Pesky's alleged conservation easement fraud; and

21 (2) GRANTED as to the United States' second
22 counterclaim for a civil fraud penalty under 26 U.S.C. § 6663 due
23 to Alan Pesky's alleged Schedule C fraud.

24 The United States has twenty days from the date of this
25 Order to file an Amended Counterclaim, if it can do so consistent

26
27 ⁶ A fortiori, if the heightened pleading standard of Rule
28 9(b) applies, the United States also fails to satisfy Rule 9(b)'s
particularity requirement for its counterclaim alleging
fraudulent reporting of Schedule C expenses.

1 with this Order.

2 DATED: January 7, 2013

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A handwritten signature in blue ink, reading "William B. Shubb", is written over a horizontal line.

WILLIAM B. SHUBB

UNITED STATES DISTRICT JUDGE

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