JOHN W. HUBER, United States Attorney (#7226)
JOHN K. MANGUM, Assistant United States Attorney (#2072)
185 South State Street, Suite 300
Salt Lake City, Utah 84111
Telephone: (801) 524-5682
Email: john.mangum@usdoj.gov

ERIN HEALY GALLAGHER, *pro hac vice*
DC Bar No. 985670, erin.healygallagher@usdoj.gov
CHRISTOPHER R. MORAN, *pro hac vice*
NY Bar No. 5033832, christopher.r.moran@usdoj.gov
Trial Attorneys, Tax Division
U.S. Department of Justice
P.O. Box 7238
Ben Franklin Station
Washington, D.C. 20044
Telephone: (202) 353-2452

IN THE UNITED STATES DISTRICT COURT FOR THE
DISTRICT OF UTAH, CENTRAL DIVISION

UNITED STATES OF AMERICA, Plaintiff, vs. RAPOWER-3, LLC, INTERNATIONAL AUTOMATED SYSTEMS, INC., LTB1, LLC, R. GREGORY SHEPARD, NELDON JOHNSON, and ROGER FREEBORN, Defendants.	Civil No. 2:15-cv-00828 DN **UNITED STATES' BRIEF IN OPPOSITION TO THE MOTION TO BIFURCATE (ECF DOC. 90)** Judge David Nuffer Magistrate Judge Brooke C. Wells

Over the decades, promoters of abusive tax shelters have pressed various objects into the service of their schemes: cattle,[1] jewelry,[2] computer systems,[3] "stamp masters" (meaning, "plates used to produce stamps"),[4] and "'reproduction masters' of [original artwork by] Picasso,"[5] just to name a few. These promoters have used such objects as the starting point for their schemes, which typically promise unfounded tax benefits, like a depreciation deduction and a tax credit related to the object, as an enticement to buy into the scheme (and thereby enrich the promoters).[6] In this case, the United States alleges that the Defendants have added yet another object to this unfortunate list of starting points for an abusive tax scheme: "solar thermal lenses."[7]

This case has been in the discovery phase since March 10, 2016.[8] Since that date, the United States has sought proportional, well-tailored discovery on all of its claims regarding Defendants' alleged abusive conduct – including making false or fraudulent statements about material matters under the internal revenue laws – and their defenses. Now, more than six months since the start of discovery and approximately ten months since this case was filed, all

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[1] *Van Scoten v. Comm'r*, 439 F.3d 1243 (10th Cir. 2006).

[2] *Jackson v. Comm'r*, 966 F.2d 598 (10th Cir. 1992).

[3] *James v. Comm'r*, 899 F.2d 905 (10th Cir. 1990).

[4] *United States v. Philatelic Leasing*, 794 F.2d 781, 782 (2d Cir. 1986).

[5] *Rose v. Comm'r*, 868 F.2d 851, 851 (6th Cir. 1989).

[6] *See James*, 899 F.2d at 905-06 (Investors in computer systems "took deductions on their personal income tax returns for depreciation, for fees to the seller for continuing management services, and they took investment tax credits for purchases of the computer systems.").

[7] *See generally* ECF Doc. 2.

[8] *See* Fed. R. Civ. P. 26(d)(1) (opening discovery once the parties have conferred under Rule 26(f)); ECF Doc. 35 ¶ 1(c) (noting that the parties conferred under Rule 26(f) on March 10, 2016).

Defendants, RaPower-3, LLC, International Automated Systems, Inc., LTB1 ("LTB"), LLC, Neldon Johnson, R. Gregory Shepard, and Roger Freeborn, move to bifurcate trial on the "nature and viability of Defendants' purported solar energy technology" from trial of the rest of the facts and issues in this case.[9] Defendants also seem to imply that discovery should be bifurcated or conducted in phases.

But even if this Court were conduct a trial focused exclusively on the "viability" of Defendants purported technology and conclude that it *is* viable today, none of the United States' claims would be resolved. A second period for discovery and trial would be required. The United States seeks, and should be granted, the requested equitable relief if this Court finds that Defendants made false or fraudulent statements (which Defendants knew, or had reason to know, were false or fraudulent), or gross valuation overstatements, about their customers' ability to secure tax benefits from participating in Defendants' scheme. Defendants allegedly made many false statements about the tax benefits that would purportedly accrue to their customers. Those statements concern, but are not limited to, the "viability" of their technology. For example, Defendants made statements about the financial structure of the transaction through which their customers purportedly purchased the solar thermal lenses and about whether, and to what extent, their customers conducted any kind of "business activities" with respect to the solar lenses. Because all of these issues (and more) must be tried to resolution, one period for discovery and trial, rather than two, is more convenient, expeditious, and economical, and would not prejudice

[9] ECF Docs. 90 & 94.

the parties.[10] Defendants do not, and cannot, meet their burden to show that bifurcation is warranted here and their motion should be denied.

I. Statement of issues and facts regarding the motion to bifurcate.

A. The claims and defenses in this case.

1. United States' claims in this case.

The United States filed its complaint in this case on November 23, 2015 seeking to enjoin Defendants pursuant to 26 U.S.C. §§ 7402 and 7408 from (among other things[11]) organizing, promoting, and selling the "solar energy scheme" that they have been promoting since or before 2010.[12] As described in the complaint, the solar energy scheme purportedly offers a "disruptive and revolutionary" approach to capturing and using solar energy. The technology underlying the solar energy scheme, purportedly invented by Neldon Johnson, uses "solar thermal lenses" on International Automated Systems, Inc.'s (IAS) "solar towers." Defendants' purported technology is, however, only the starting point of their solar energy scheme.

Defendants make money by selling the "lenses" to customers. As of 2012, they claimed to have "a thousand [customers] from all corners of the United States."[13] As of March 2015,

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[10] *See* Fed. R. Civ. P. 42(b).

[11] The United States does not claim to set forth, in this brief, *all* of the reasons that Defendants should be enjoined. The facts and allegations discussed herein show the reasons that Defendants' requested bifurcation will not be dispositive of the United States' claims or Defendants' defenses in this case. They are not an exhaustive recitation of every fact or legal argument that the United States may offer at trial to show that this Court should grant the equitable relief requested, which includes an injunction against Defendants' continued promotion of their solar energy scheme and disgorgement of Defendants' gross receipts from the scheme.

[12] ECF Docs. 2 and 35 ¶ 1(a).

[13] Pl. Ex. A, a copy of an email dated Jul. 19, 2012 with an attachment, received by the United States from one of Defendants' customers, at Bates numbered page Gregg_P&R-002666. If a document has been numbered as an exhibit in discovery, the United States will use the same exhibit number for that document throughout the litigation. If not, the United States will identify the exhibit by letter.

Shepard told the IRS that "RaPower[-]3 should expand its member base by thousands of [customers]," all of whom would be "claiming tax benefits."[14]

The United States alleges that so many customers are willing to buy the lenses because Defendants assure them that, in return, they will receive tax benefits far greater than the customers' cash outlay to join the scheme. The underpinnings of Defendants' solar energy scheme are their assertions that: 1) customers who buy lenses are in a "trade or business" or have bought the lenses for the purpose of making a profit; 2) customers may deduct such "business" expenses, consisting mostly of depreciation on the lenses, from their "ordinary income" like wages from their full-time jobs; and 3) customers may claim a solar energy credit to further reduce their tax liability. The United States also alleges that Defendants falsely inflate the value of the lenses they sell over the correct value of such lenses to increase the tax benefits they promote to their customers, which inflates the unwarranted deductions and corresponding harm to the United States Treasury.

a. The United States alleges that Defendants' customers, by buying lenses are not in a "trade or business" or engaged in an activity for profit.

Under the proper circumstances, the Internal Revenue Code allows a taxpayer engaged in a trade or business certain tax deductions for expenses the taxpayer incurs while generating income. There are specific requirements to meet before a taxpayer is entitled to these deductions. One requirement is that the taxpayer must have undertaken activity in a "trade or business" or "for the production of income" in good faith, with the primary purpose of the activity to make a

[14] Pl. Ex. 10, a true and correct copy of a letter dated March 20, 2015, from IRS files, at 6.

profit.[15] The taxpayer's activity may be disregarded – and its related tax benefits disallowed – if the transaction lacks economic substance.[16] "Depending on the execution, [any] transaction can amount to nothing more than a sham."[17]

According to the Tenth Circuit, "all of the unique circumstances of a [situation] must be considered" in the analysis of whether a taxpayer has undertaken alleged business activity in good faith.[18] The factfinder's analysis may include the "hobby loss" provisions under 26 U.S.C. § 183 or the "economic substance" test under 26 U.S.C. § 7701(o) and related case law.[19] Under § 183, commonly relevant facts include: 1) the manner in which the taxpayer carries on the activity; 2) the expertise of the taxpayer or his advisors; 3) the time and effort expended by the taxpayer; 4) the expectation that assets used in the business may appreciate in value; 5) the success of the taxpayer in carrying on similar or dissimilar activities; 6) the taxpayer's history of income or losses with respect to the activity; 7) the amount of occasional profits, if any, which are earned; 8) the financial status of the taxpayer; and 9) elements of personal pleasure or recreation.[20] Under the Treasury Regulations, "greater weight" in this analysis "is given to objective facts than to the taxpayer's mere statement of his intent."[21]

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[15] *See* 26 U.S.C. §§ 162, 183, 7701(o); *Nickeson v. Comm'r*, 962 F.2d 973, 976-77 (10th Cir. 1992).

[16] *See* § 7701(o).

[17] *United States v. Stover*, 731 F. Supp. 2d 887, 891 (W.D. Mo. 2010). (rejecting a promoter defendant's argument "that certain transactions can be lawful without regard to whether the ones he promoted actually were").

[18] *Nickeson*, 962 F.2d at 977.

[19] *Id.* at 976-77.

[20] *Id.* at 976 n.2; 26 C.F.R. § 1.183-2(b).

[21] 26 C.F.R. § 1.183-2(a).

Under the economic substance test, a transaction[22] has economic substance *only if* 1) "the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position," *and* 2) "the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[23] Among the facts relevant to this conjunctive test are whether 1) the transaction is marketed "on the basis of projected tax benefits," 2) the transaction features "[a] grossly inflated purchase price set without bargaining," 3) a taxpayer failed "to inquire into the potential profitability of the program," 4) a taxpayer retained "control" over activities related to or arising out of the transaction, and 5) the transaction featured "nonrecourse indebtedness."[24]

In light of the foregoing legal framework, the United States alleges that Defendants' customers are not in a "trade or business" related to the lenses they purportedly purchase – but Defendants tell them that they are.[25] Defendants assert that their customers are in the "trade or business" of "leasing" solar lenses,[26]or in the "solar energy business,"[27] or sometimes both.[28]

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[22] "'[T]ransaction' includes a series of transactions." 26 U.S.C. § 7701(o)(5)(D).

[23] 26 U.S.C. § 7701(o)(1). Subsection (o) applies to all transactions entered into after it was enacted in 2010. Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152, § 1409 (a) & (e)(1). For purposes of this brief, the United States will use the codified economic substance test, but notes that the economic substance doctrine, as articulated by the Tenth Circuit, would apply to transactions entered on or before enactment of § 7701(o). *See Blum v. Comm'r*, 737 F.3d 1303, 1310 (10th Cir. 2013) (For a pre-codification transaction, "an economic substance analysis requires [a court] to look at subjective motivation [for the transaction] and [the transaction's] objective profit potential.").

[24] *Nickeson*, 962 F.2d at 977 (citations omitted).

[25] Pl. Ex. B, a true and correct copy of a printout from a prior version of www.rapower3.com.

[26] Pl. Ex. 32, a true and correct copy of an email dated November 11, 2013, received by the United States from one of Defendants' customers.

[27] Pl. Ex. 89, a true and correct copy of an email dated January 17, 2014, received by the United States from one of Defendants' customers with its attachment, at 1-2 (Shepard wrote a letter for customers to use to defend themselves in audit by the Oregon Department of Revenue that says "I am engaged in the solar energy business.").

Defendants base their assertion that their customers are in a "trade or business" on the structure of the financial transaction through which a customer purchases lenses.[29] By buying the lenses and holding the lenses out for lease, according to Defendants, the customer is in the "trade or business of "holding property out for lease."[30] Defendants claim that the lenses need not actually be in use as solar-energy-producing equipment for the customer to claim the tax benefits Defendants promote.[31] It is enough, they say, that the customer "leases out" the lenses to LTB through the operation and maintenance agreement.[32]

b. The United States alleges that, even if Defendants' customers are in a "trade or business" or are engaged in an activity for profit, they may not deduct their purported "business" expenses against their ordinary income.

One "business" deduction is for depreciation, the "wear and tear" on property either acquired for use in the taxpayer's "trade or business" or held by the taxpayer "for the production of income."[33] Other allowable deductions are "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on [the taxpayer's] trade or business."[34] As the Tenth Circuit explained in *Van Scoten*, there are limits to the way in which a taxpayer may deduct "business" expenses under 26 U.S.C. § 469: before § 469 was enacted in 1986, a taxpayer could

(…continued)

[28] *Id.* at 2-4.

[29] *E.g.*, Pl. Ex. 25, a true and correct copy of a printout from a prior version of www.rapower3.com.

[30] *E.g.*, *id.*

[31] Pl. Ex. 10 at 3; Pl. Ex. 89.

[32] Pl. Ex. 10 at 3; Pl. Ex. 89.

[33] 26 U.S.C. § 167(a).

[34] 26 U.S.C. § 162(a).

use "passive activity losses to offset non-passive activity income," such as wages from an employer.[35] Congress's decision to eliminate the ability to offset active income with passive losses by enacting § 469 "was intended to limit the financial incentive to structure traditional tax shelters."[36] Therefore, a taxpayer may not deduct "passive activity losses, except insofar as the losses are used to offset passive activity income."[37]

A "passive activity" is "any activity (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."[38] A taxpayer "materially participates" in an activity only if the taxpayer's involvement in the activity is regular, continuous, and substantial.[39] A Temporary Treasury Regulation identifies a number of fact-specific tests to determine whether a taxpayer has "materially participated" in any trade or business.[40] They include the number of hours the taxpayer has participated in the activity during the tax year and the kinds of activities the taxpayer performed for the business.[41] Work done by a taxpayer as an *investor* in an activity (such as "[m]onitoring the finances or operations of the activity in a non-managerial capacity" or "[s]tudying and reviewing financial statements or

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[35] *Van Scoten*, 439 F.3d at 1249 n.4.

[36] *Id.*

[37] *Id.*

[38] 26 U.S.C. § 469(c)(1).

[39] 26 U.S.C. § 469(h).

[40] *See generally* 26 C.F.R. § 1.469-5T.

[41] *See* 26 C.F.R. § 1.469-5T(a), (b), (f).

reports on operations of the activity") is not "participation" in the activity, "unless the individual is directly involved in the day-to-day management or operations of the activity."[42]

Whether or not in a "trade or business," a taxpayer may be allowed to deduct losses from certain activity up to the amount that the taxpayer has "at risk" in the activity.[43] The amount that a taxpayer has "at risk" includes the "amount of money and the adjusted basis of other property contributed by the taxpayer to the activity" and certain "amounts [that the taxpayer] borrowed with respect to such activity."[44] A taxpayer is considered "at risk" with respect to amounts he borrows to use in an activity if he is personally liable for repaying the debt or has pledged collateral other than property used in the activity as security for the debt.[45] With certain exceptions, a taxpayer is considered *not* "at risk" for amounts in an activity that the taxpayer borrows from "any person who has an interest in such activity" or is related to such an interested person.[46]

The United States alleges that (even if Defendants' customers could be construed as being in a "trade or business" relating to the solar lenses they purportedly purchase, which they cannot), Defendants' customers did not materially participate in such trade or business – but Defendants tell them that they do. RaPower-3's website in March 2015 contained the following statement: "You are actively engaged in your solar business . . . and since you do most or all of

[42] 26 C.F.R. § 1.469-5T(f)(2)(ii)(A) & (B).

[43] 26 U.S.C. § 465(a), (b).

[44] 26 U.S.C. § 465(b)(1).

[45] 26 U.S.C. § 465(b)(2).

[46] 26 U.S.C. § 465(b)(3)(A).

the work in the business, you are also a material participant."[47] On the same website at the same time, however, RaPower-3 told customers how *little* any customer would have to do with respect to the lenses: "Since LTB installs, operates and maintains your lenses for you, having your own solar business couldn't be simpler or easier."[48]

The United States further alleges that, even if Defendants' customers may claim business expenses, including depreciation, on the solar lenses they purportedly purchase, they may not claim the full amount Defendants tell them that they can. Defendants tell their customers that they may claim federal tax deductions based on the "full purchase price" ($3,500) of each lens that the customer purportedly buys.[49] But Defendants' customers are not "at risk" with respect to the full $3,500 in the year they purportedly purchase their lenses and claim the purportedly related tax benefits. Defendants tell customers that they may pay just $105 per lens in the year of purchase.[50] Then they may pay $945 more in the *next* year – because they pay with their "tax refunds/savings"[51] generated by their participation in the scheme. Then RaPower-3 "finance[s] the rest," in the amount of $2,450.[52] RaPower-3 reminds customers that they will not even make the payments for the remaining $2,450: LTB will make them from the "rental income" that the

[47] Pl. Ex. 25 at 1.

[48] Pl. Ex. 19, a true and correct copy of a printout from a prior version of www.rapower3.com, at 1.

[49] *Id.* at 2; Pl. Ex. 34, a true and correct copy of a printout from a prior version of www.rapower3.com, at 2.

[50] Pl. Ex. C, a true and correct copy of a printout from a prior version of www.rapower3.com, at Bates numbered page US001678.

[51] *Id.*

[52] *Id.*

lenses produce.[53] The United States alleges that the customer is not personally liable to pay any of the "financed" amount; the only collateral for the "financed" amount is the lens itself.[54] And the "financier" is RaPower-3.

c. The United States alleges that Defendants' customers are not eligible for the solar energy credit under 26 U.S.C. § 48.

Under § 48, a taxpayer may be allowed an "energy credit" that reduces his income tax liability in a given year.[55] There are specific requirements to meet before a taxpayer is entitled to the energy credit under § 48. The amount of energy credit that a taxpayer may be allowed depends, in part, on the "basis of each energy property placed in service" during the tax year for which the taxpayer claims the credit.[56] Among other qualifying requirements, "energy property" means equipment with respect to which depreciation is allowed, and "which uses solar energy [1] to generate electricity, [2] to heat or cool (or provide hot water for use in) a structure, or [3] to provide solar process heat."[57]

The United States alleges that the solar lenses that Defendants' customers purportedly purchase are not eligible for the energy credit under § 48. But Defendants tell their customers

[53] *Id.*

[54] ECF Doc. 2 ¶¶ 63, 66.

[55] 26 U.S.C. §§ 48(a), 46(2), 38(a) & (b)(1).

[56] 26 U.S.C. § 48(a)(1).

[57] 26 U.S.C. § 48(a)(3)(A)(i) & (C); *see also* 26 C.F.R. § 1.48-9(d)(1).

that they are,[58] in spite of (as recently as February 19, 2016) having "no . . . proof that [their purported solar] towers are up and running."[59]

2. Defendants' defenses.

Defendants deny the United States' allegations. They contend that their solar energy scheme is not abusive; that the statements they have made in promoting the scheme are "grounded in fact and law" and that they were "provided tax advice from legal professionals regarding associated tax credits and deductions."[60]

B. Procedural posture.

1. The United States' discovery to date.

In light of the allegations and defenses, the parties agreed that discovery would be needed on statements made by Defendants regarding the so-called technology and about any related federal tax deductions, credits or benefits they promote.[61] The extent of Defendants' gross receipts from the scheme is also relevant and discoverable, not only for disgorgement but also for the appropriateness of the injunctive relief the United States seeks.[62] The parties explicitly agreed that discovery in this case would proceed on all issues at the same time and would not be conducted in phases.[63]

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[58] Pl. Ex. 26, a true and correct copy of a printout from a prior version of www.rapower3.com, at 1-2.

[59] Pl. Ex. D, a copy of an email dated February 19, 2016, received by the United States from one of Defendants' customers, at 1.

[60] ECF Doc. 35 ¶ 1(a), Defendants' Claims and Defenses; *see also* ECF Doc. 22, Defenses; ECF Doc. 26, Defenses.

[61] *See* 26 U.S.C. § 6700(a)(2)(A); ECF Doc. 2 ¶¶ 157-159; ECF Doc. 35 ¶ 2(a).

[62] ECF Doc. 35 ¶ 2(a)(4) & (5).

[63] ECF Doc. 35 ¶¶ 1(a) & 2(b); *see also* ECF Doc. 37 (scheduling order contains no provision for phased discovery).

The United States has made discovery requests to all parties to this case (both requests for the production of documents and interrogatories) and has sought appropriate third-party discovery (both subpoenas for the production of documents and subpoenas for deposition). Each discovery request or third-party subpoena has been tailored to the person receiving the request and asks for relevant information that that person or entity has or may have. For example, the United States' discovery requests to Defendants seek documents and information relevant to their actions organizing the solar energy scheme; the nature and viability of their technology; and statements they made or furnished, or caused another to make or furnish, regarding the tax consequences to a person who may buy in to their solar energy scheme.[64] The United States has also issued subpoenas to Defendants' customers on the topics of Defendants' statements regarding the tax consequences to a person who may buy in to their solar energy scheme, which include statements Defendants made regarding the nature and viability of their technology, other statements Defendants made regarding the customers' ability to secure tax benefits, and the cost of the solar lenses the customer purportedly purchased.[65] In depositions, the United States has asked customers about the kinds of facts relevant to whether they are in a trade or business or other activity for the production of income, whether they materially participated in such activity, and whether and to what extent the customers had money "at risk" in any trade, business, or other activity related to the lenses they purportedly purchased.[66]

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[64] *E.g.*, Pl. Ex. E, a true and correct copy of excerpts from the United States First Requests for the Production of Documents to Defendant Neldon Johnson.

[65] *E.g.*, Pl. Ex. 35.

[66] *E.g.*, Pl. Ex. F, a true and correct copy of excerpts of the deposition of Frank F. Lunn, Aug. 1, 2016, at 59:22-15, 109:9-121:14.

Defendants have resisted nearly all of the discovery requests and many of the third-party subpoenas for the production of documents that the United States has sought. Their primary, and often sole, objection to the production of documents or information (which they reiterate in their motion for bifurcation) is that their purported solar technology is confidential and should not be produced to the United States without "appropriate securities."[67] The United States has shown that Defendants themselves have publicized some elements of this purportedly "confidential" technology.[68]

But the United States also acknowledges that there may be some elements of Defendants' purported solar energy technology which Defendants may have kept secret. Accordingly, and pursuant to Magistrate Judge Wells' recent order in this case,[69] the parties are negotiating terms of a protective order that will protect Defendants' purportedly confidential technology from disclosure that would cause them competitive or other financial harm and will ensure that the United States' substantive rights are protected. A resolution of the terms of the protective order is likely by November 4, 2016.[70]

[67] ECF Doc. 90 at 6; *see also, e.g.*, ECF Doc. 83.

[68] *E.g.*, ECF Doc. 85.

[69] ECF Doc. 92.

[70] *See* ECF Doc. 92 at 6.

II. A single trial will be more convenient, would expedite and economize resolution of this case, and will reduce prejudice to the parties.

A "general principle" in federal district court is that "a single trial tends to lessen the delay, expense and inconvenience to all parties."[71] "[A] single trial generally is more convenient, subject to fewer delays, and is less costly than multiple trials."[72] If a defendant wishes an issue to be tried separately from the case as a whole, the burden is on the defendant to "convince the court that a separate trial [on that issue] is proper" in the interests of convenience, of expediting and economizing resolution of the matter, or of avoiding prejudice.[73] "Bifurcation is not an abuse of [the district court's] discretion if such interests favor separation of issues and the issues are clearly separable."[74] Bifurcation is most appropriate when "resolution of a single claim or issue could be dispositive of the entire case."[75] But when the issue proposed for bifurcation will *not* eliminate the need for trial on other issues or when the evidence regarding all issues will overlap, "bifurcation would not foster judicial economy."[76]

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[71] *Patten v. Lederle Labs.*, 676 F. Supp. 233, 238 (D. Utah 1987) (Greene, J.) (quotation omitted), *quoted in Zachwieja v. Am. Family Mut. Ins. Co.*, 2009 U.S. Dist. LEXIS 28298, at *5 (D. Utah Mar. 27, 2009) (Kimball, J.).

[72] *McKeen v. USAA Cas. Ins. Co.*, 2016 U.S. Dist. LEXIS 107107, at *3 (D. Utah Aug. 11, 2016) (quotation omitted) (Nuffer, J.)

[73] *Patten*, 767 F. Supp. at 238 (quotation omitted), *quoted in Zachwieja*, 2009 U.S. Dist. LEXIS 28298, at *5; *accord McKeen*, 2016 U.S. Dist. LEXIS 107107, at *3; *see also* Fed. R. Civ. P. 42(b) ("For convenience, to avoid prejudice, or to expedite and economize, the court may order a separate trial of one or more separate issues, claims, crossclaims, counterclaims, or third-party claims.").

[74] *Angelo v. Armstrong World Indus.*, 11 F.3d 957, 964 (10th Cir. 1993).

[75] *Drennan v. Maryland. Cas. Co.*, 366 F. Supp. 2d 1002, 1007 (D. Nev. 2005); *accord Easton v. Boulder*, 776 F.2d 1441, 1447 (10th Cir. 1985).

[76] *Cadet Mfg. Co. v. Am. Ins. Co.*, 2006 U.S. Dist. LEXIS 35357, at *8-9 (W.D. Wash. June 1, 2006); *Id.* at *7-8 ("In Washington, an insured may maintain suit against an insurer for bad faith investigation of a claim regardless of whether the insurer correctly determined that there was no coverage. Thus . . . a resolution of the coverage claim adverse to Cadet will not dispose of the necessity of a trial on bad faith claims.").

Defendants seem to be asking that this Court bifurcate this case so that the parties would move forward with discovery and trial solely on the "nature and viability of Defendants' purported solar energy technology."[77] Then, only if this Court determines that the "technology is [not] viable" would the parties move forward on discovery of the remaining issues in this case and present them at trial.[78] Defendants cite cases involving patent and antitrust claims and claims of unconstitutional conduct by police officers, in which a municipality is sued along with the officer(s). In both such types of cases, bifurcation is at least a somewhat regular practice when the issues lend themselves to separation.[79] But even in those types of cases, "separation of issues for trial is not to be routinely ordered."[80] Instead, it may be "encouraged where experience has demonstrated its worth."[81] There is no "demonstrated worth" of bifurcation in cases like this one, involving allegations that the defendants promote an abusive tax scheme. Instead, the practice in federal district courts across the United States is to address these types of cases in whole.[82]

The factors in the bifurcation analysis all weigh in favor of a single period for discovery and a single trial in this case.[83] Even if this Court were to find that Defendants' purported solar

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[77] ECF Doc. 90 at 2.

[78] *See id.* at 4.

[79] *E.g.*, *Ecrix Corp. v. Exabyte Corp.*, 191 F.R.D. 611, 614 (D. Colo. 2000); *but see Lam Research Corp. v. Schunk Semiconductor*, 65 F. Supp. 3d 863, 865 (N.D. Cal. 2014) ("While patent cases frequently present complicated liability and damages question, bifurcation in patent cases remains the exception rather than the rule.").

[80] *Angelo*, 11 F.3d at 964 (quoting Fed. R. Evid. 42(b) advisory committee's note).

[81] *Id.* (quoting Fed. R. Evid. 42(b) advisory committee's note).

[82] *E.g.*, *United States v. Elsass*, 978 F. Supp. 2d 901 (S.D. Ohio 2013); *United States v. Campbell*, 704 F. Supp. 715 (N.D. Tex. 1988).

[83] *See Skyline Potato Co. v. Tan-O-On Mktg.*, 2012 U.S. Dist. LEXIS 87097, at *33-34 (D.N.M. June 12, 2012) (denying motion to bifurcate because "a single trial . . . will be a simpler course of action administratively" and "it is not likely that issues will be inseparable or confusing for the Court at a bench trial"); *United States v. Real Prop. Located at Layton*, 2011 U.S. Dist. LEXIS 25715, at *5-6 (D. Utah Mar. 14, 2011) (Stewart, J.).

energy technology is now, or has ever been, "viable" there must be discovery and trial on other issues in this case, such as their statements about the financial structure of the transaction through which their customers purportedly purchased the solar thermal lenses; whether, and to what extent, their customers conducted any kind of "business activities" with respect to the solar lenses; and what Defendants knew or had reason to know about the falsity of their statements to customers about securing tax benefits.

A. The interests of convenience, and expediting and economizing resolution of this case, counsel in favor of a single trial.

One of the statutes under which the United States seeks an injunction is 26 U.S.C. § 7408. Section 7408(a) authorizes a district court to enjoin any person from engaging in conduct subject to penalty under 26 U.S.C. § 6700 if injunctive relief is appropriate to prevent recurrence of that conduct or any other activity subject to penalty under the Internal Revenue Code. Section 6700 imposes a civil penalty on any person who (1) either organizes or assists in the organization of a plan or arrangement or participates in the sale of any interest in a plan or arrangement; and (2) makes or furnishes, or causes another to make or furnish, certain statements. One such statement subject to penalty is a statement with respect to the securing of a tax benefit by reason of holding an interest in an entity or participating in a plan or arrangement that the person knows or has reason to know is false or fraudulent as to any material matter.[84] Another such statement subject to penalty is a "gross valuation overstatement as to any material matter."[85] A gross valuation overstatement is "any statement as to the value of any property or services" if the value

[84] 26 U.S.C. § 6700(a)(2)(A).

[85] 26 U.S.C. § 6700(a)(2)(B).

of the property or services is directly related to the amount of any tax deduction or credit and the stated value is more than 200 percent of the correct value of the property or services.[86]

Both provisions of § 6700 use the phrase "material matter." "Material matters are those which would have a substantial impact on the decision-making process of a reasonably prudent investor and include matters relevant to the availability of a tax benefit."[87] Statements about "material matters" include those that "directly address[]" the tax benefits purportedly available to a participant in a tax scheme and those that "concern[] factual matters that are relevant to the availability of tax benefits."[88] The United States alleges that Defendants made false or fraudulent statements as to both kinds of material matters, on numerous topics under the internal revenue laws.

The state of Defendants' purported technology is one "material matter" that is relevant to some of the issues to be tried. Those facts will be relevant to the issue of whether Defendants made false or fraudulent statements (which they knew or had reason to know were false or fraudulent) to their customers, under § 6700(a)(2)(A), regarding whether their customers were in a trade or business related to the lenses. One of the facts relevant to whether a customer was in a trade or business is whether the customer engaged in the activity to make a profit. Therefore, if Defendants told customers to expect income from their lenses due to the production of energy, but Defendants knew, or had reason to know, that their technology was not in a state of sufficient

[86] 26 U.S.C. § 6700(b)(1).

[87] *United States v. Campbell*, 897 F.2d 1317, 1320 (5th Cir. 1990); *United States v. Buttorff*, 761 F.2d 1056, 1062 (5th Cir. 1985); *Anderson v. IRS*, 442 F. Supp. 2d 365, 373 (E.D. Tex. 2006) ("Material matters include matters relevant to the availability of a tax benefit.").

[88] *Campbell*, 897 F.2d at 1320.

readiness to generate such income at the time the statement was made, this Court could conclude that Defendants made a false or fraudulent statement as to a material matter and had engaged in conduct subject to penalty under § 6700(a)(2)(A).

Similarly, if Defendants told customers that their lenses qualify as "solar energy property" under § 48, but Defendants but Defendants knew, or had reason to know, that their technology was not using solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat for any purpose that Congress intended to incentivize, this Court could conclude that Defendants made a false or fraudulent statement as to a material matter and had engaged in conduct subject to penalty under § 6700(a)(2)(A). Facts about Defendants' technology will also assist the Court in determining the "correct valuation" of the lenses that Defendants sold and whether Defendants' statements of the lenses' value exceeded 200 percent of that amount, under § 6700(a)(2)(B).

But facts regarding the "nature and viability of Defendants' purported solar energy technology" are not dispositive of whether Defendants made false or fraudulent statements about securing tax benefits. Even if this Court were to find that Defendants' solar energy technology is "viable" (in any respect), this Court would still have to evaluate all of the statements Defendants have made about *other* "material matters" while promoting their solar energy scheme to determine whether they are false or fraudulent, or whether they constitute gross valuation overstatements. Such statements include Defendants' factual and legal statements that, by signing the contracts and purportedly buying lenses, their customers were in a trade or business, or were engaged in an activity for profit; that their customers "materially participated" in such trade, business, or activity for profit; and that their customers could use the full "purchase price"

of $3,500 as the starting point for their deductions and credit because that was the amount their customers had "at risk." Facts relevant to these issues *include* information about the state of Defendants' purported solar energy technology, but are not limited to that topic. Other facts are relevant to these issues and must be considered by this Court, including what Defendants' customers actually did with respect to the lenses and any related business activity, what their customers told Defendants about their activities, what Defendants knew about their customers and their purported business activities, how much their customers paid Defendants for their lenses, and when they made such payments. Additionally, this Court would have to find facts regarding Defendants' state of mind – whether they knew, or had reason to know – that they were making false or fraudulent statements regarding material matters under the internal revenue laws, from at least 2010 to the present date. Accordingly, one period for discovery and one trial, rather than two, will be more convenient, expeditious, and economical to resolve the United States' claims for equitable relief in this case.

B. There is no risk of cognizable prejudice to Defendants if this case proceeds through a single discovery period to a single trial.

The primary "prejudice" that Rule 42(b) seeks to avoid is with respect to claims that will be tried to a jury. Prejudice may accrue to a party if the jury could be confused due to complex issues or multiple parties with potentially competing claims.[89] The risk that a jury may have a strong emotional reaction to certain evidence relevant to one issue or party, but not to another

[89] *Hicks v. Community Educ. Ctrs., Inc.*, 2013 U.S. Dist. LEXIS 84076, at *2 (D. Colo. June 14, 2013); *SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 801 F. Supp. 517, 528 (D. Utah 1992) (Benson, J.).

issue or party, may also result in prejudice.[90] Defendants do not claim that they will be prejudiced in these ways in this case, which will be tried to this Court.[91] Federal district courts across the country routinely address tax cases similar to this one, with complex issues of fact.[92]

Rather, Defendants' sole argument that they will be "prejudiced" without bifurcation is founded in their assertions that the United States has conducted too much discovery, or not the right kind of discovery, and not in the order that Defendants would prefer. Defendants appear to wish that discovery were being conducted in phases, with the parties addressing the facts regarding Defendants' purported technology first (and, it seems, solely among the parties without any third-party discovery) and all of the remaining issues second. But "bifurcation under [R]ule 42 deals more with conducting separate trials . . . rather than conducting separate discovery."[93] This should be particularly true when the party seeking bifurcation agreed to a unitary discovery period at the beginning of the case, as Defendants did here.[94]

Defendants also claim prejudice in light of their confidentiality objections to the United States' third-party discovery requests to date.[95] The United States has requested documents from

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[90] *See Belisle v. BNSF Ry. Co.*, 697 F. Supp. 2d 1233, 1250-51 (D. Kan. 2010); *North Dakota Fair Hous. Council, Inc. v. Allen*, 298 F. Supp. 2d 897, 899 (D.N.D. 2004).

[91] *See Skyline Potato Co.*, 2012 U.S. Dist. LEXIS 87097, at *33-34 ("it is not likely that issues will be inseparable or confusing for the Court at a bench trial"); *Real Prop. Located at Layton*, 2011 U.S. Dist. LEXIS 25715, at *6 (in a civil forfeiture case, which would be tried to the court, there was no prejudice to a party that "a jury will be confused by allegations of wrongdoing by other claimants" to the property at issue or that the party's "claim will be lost or confused with those of other claimants").

[92] *E.g.*, *Elsass*, 978 F. Supp. 2d 901; *Campbell*, 704 F. Supp. 715.

[93] *Skyline Potato Co*, 2012 U.S. Dist. LEXIS 87097, at *37-38 (rejecting parties' arguments that they would "face prejudice based on the additional time and resources they must spend during trial and discovery" if the bifurcation motion were not granted).

[94] ECF Doc. 35 ¶ 2(b) ("Discovery Phases. Discovery will not be conducted in phases.")

[95] ECF Doc. 90 at 4-6.

and issued interrogatories about their technology to all Defendants. But Defendants, in light of the unsettled protective order issue (which also affects Defendants' arguments about third-party discovery), have not produced such documents or responded to such interrogatories. But because the protective order issue will be resolved soon, Defendants will have "appropriate securities"[96] in place to promptly produce the documents and information, in their possession, custody, or control, that go to the viability of their technology. Once the documents and information are produced, United States plans to proceed expeditiously to evaluate Defendants' purported technology. Counsel for the United States will determine how long it will take our likely expert witness to review Defendants' productions, and will propose dates for a site visit as soon as possible. Therefore, Defendants' objections to the United States' discovery will soon be moot and they will suffer no prejudice.

In sum, Defendants have offered no reason that the parties cannot proceed with discovery on this topic along with other topics relevant to the issues to be tried. Therefore, even if this Court were to conclude that a separate trial is warranted (which it is not), "bifurcation of the trial does not necessarily require bifurcation of discovery."[97] Proceeding with one discovery period will allow the parties to be "better informed with regard to settlement efforts" and "will expedite resolution of the entire matter by permitting the second trial, if necessary, to commence immediately after the first."[98] A single discovery period for a case is in the best interests of convenience and economy when "separate discovery periods for each claim would be

[96] *Id.* at 6.

[97] *Drennan*, 366 F. Supp. 2d at 1008.

[98] *Id.*; *accord Ecrix Corp.*, 191 F.R.D. at 614; *North Dakota Fair Hous. Council*, 298 F. Supp. 2d 897 at 899-900.

unjustifiably expensive and time consuming,"[99] as it would here when the facts proposed for separate trial would not resolve any issue or defense. Further, a single period for discovery would reduce the prejudice to the United States that could accrue from the delay caused by bifurcation, if the United States proves its allegations and shows that the equitable relief it requests is appropriate. Prejudice from such delay "is real, and cannot be mitigated by any action short of denying the request for separate trials."[100]

III. Conclusion

Whether, and to what extent, Defendants' purported solar energy technology has ever been or is now "viable" will bear on the ultimate legal issues to be tried in this case: whether Defendants should be enjoined, and compelled to provide the other equitable relief requested in the United States' complaint, because of their past and ongoing conduct that is abusive of the internal revenue laws. But factual findings on that topic will not be dispositive of the United States' claims in this case. This Court will also need to evaluate Defendants' statements and other facts that are not linked to the "viability" of their purported technology. Therefore, the interests of a just, speedy, and inexpensive resolution of this case are best served by proceeding with discovery and trial on all claims and defenses in this matter. The motion for bifurcation should be denied.

[99] *Zachwieja*, 2009 U.S. Dist. LEXIS 28298, at *7-8.

[100] *Senorx, Inc. v. Hologic, Inc.*, 920 F. Supp. 2d 565, 568-69 (D. Del. 2013)

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Respectfully submitted,

/s/ Erin Healy Gallagher
ERIN HEALY GALLAGHER
DC Bar No. 985760
Email: erin.healygallagher@usdoj.gov
Telephone: (202) 353-2452
CHRISTOPHER R. MORAN
New York Bar No. 5033832
Email: christopher.r.moran@usdoj.gov
Telephone: (202) 307-0834
Trial Attorneys, Tax Division
U.S. Department of Justice
P.O. Box 7238
Ben Franklin Station
Washington, D.C. 20044
FAX: (202) 514-6770
ATTORNEYS FOR THE UNITED STATES

CERTIFICATE OF SERVICE

I hereby certify that on October 3, 2016, the foregoing document was electronically filed with the Clerk of the Court through the CM/ECF system, which sent notice of the electronic filing to the following:

Justin D. Heideman
HEIDEMAN & ASSOCIATES
2696 North University Avenue, Suite 180
Provo, Utah 84604
jheideman@heidlaw.com
ATTORNEY FOR RAPOWER-3, LLC, INTERNATIONAL AUTOMATED SYSTEMS, INC., LTB1, LLC, and NELDON JOHNSON

Donald S. Reay
MILLER, REAY & ASSOCIATES
donald@reaylaw.com
ATTORNEY FOR R. GREGORY SHEPARD AND ROGER FREEBORN

/s/ Erin Healy Gallagher
ERIN HEALY GALLAGHER
Trial Attorney