IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MASSACHUSETTS

In re:	Chapter 11
TELEXFREE, LLC, TELEXFREE, INC., and TELEXFREE FINANCIAL, INC.,	Case No. 14-40987 Case No. 14-40988 Case No. 14-40989
Debtors.	Jointly Administered
STEPHEN DARR,	Adv. Proc. No. 18-04091
Plaintiff and Counterclaim Defendant,	Judge Melvin S. Hoffman
v.	
UNITED STATES OF AMERICA, DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE,	
Defendant and Counterclaim Plaintiff.	

UNITED STATES OF AMERICA'S SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT

Defendant and Counterclaim Plaintiff United States of America, named and sued as United States of America, Department of Treasury, Internal Revenue Service, hereby moves, in accordance with Federal Rule of Bankruptcy Procedure 56, for partial summary judgment[1] against Plaintiff and Counterclaim Defendant Stephen Darr, the Chapter 11 Trustee. In support thereof, the United States submits contemporaneously with this motion (1) the United States' Statement of Material Facts in Support of Its Second Motion for Partial Summary Judgment, and

[1] This Motion for Partial Summary Judgment addresses the remaining issues not covered in the pending cross-motions for partial summary judgment (Docs. 12, 21).

its attached Exhibits 1 to 14[2]; (2) and the United States' Brief in Support of Its Second Motion for Partial Summary Judgment.

As explained in the brief and demonstrated by the undisputed material facts, the United States is entitled to summary judgment on Counts I, II, and III of the Complaint, and on the Counterclaim. The Court should grant summary judgment in favor of the United States on Count I of the Complaint because "the TelexFree Credits" (*i.e.*, the amounts that TelexFree promised to pay Ponzi scheme participants for "advertising" the scheme and as "commissions" for recruiting new victims into the scheme) and the alleged bad debt owed by a related foreign entity are not deductible pursuant to 26 U.S.C. §§ 162 and 166. Because TelexFree is not entitled to those deductions, the Internal Revenue Service properly disallowed those deductions on TelexFree's tax returns for 2012, 2013, and 2014. Accordingly, the Court should grant summary judgment in favor of the United States on Count II by holding that the Trustee is not entitled to retain the 2013 refund or to obtain a refund for 2012, and on Count III by holding that the Internal Revenue Service's proof of claim related to 2013 and its request for payment of administrative expenses related to both 2013 and 2014 are allowed as filed.

The Court further should grant summary judgment in favor of the United States on its Counterclaim, by disallowing any turnover requests or claims for refund, and holding that the Trustee is holding $15,532,440.39 as an erroneous refund issued to Trustee with respect to TelexFree, LLC's federal income taxes for the year 2013, which is not property of the estate and should be turned over to the United States.

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[2] Exhibits 3, 4, 5, 8, and 11 are offered as proof of what was filed with the Internal Revenue Service, and not for the truth of the matters asserted therein.

WHEREFORE, the United States of America respectfully requests that the Court grant the United States' motion for partial summary judgment.

Dated: September 20, 2019

Respectfully submitted,

RICHARD E. ZUCKERMAN
Principal Deputy Assistant Attorney General
U.S. Department of Justice, Tax Division

*/s/ Lauren E. Hume*________________
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CERTIFICATE OF SERVICE

I hereby certify that on this 20th day of September, 2019, I electronically filed the foregoing document with the Clerk of Court using the CM/ECF system, which will send notification of such filing to all registered CM/ECF participants. There are no parties that require conventional service.

*/s/ Lauren E. Hume*______________
LAUREN E. HUME
Trial Attorney
United States Department of Justice, Tax Division

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	)	
Debtors.	)	Jointly Administered
	)	
	)	
STEPHEN DARR,	)	Adv. Proc. No. 18-04091
	)	
Plaintiff and	)	Judge Melvin S. Hoffman
Counterclaim Defendant,	)	
	)	
v.	)	
	)	
UNITED STATES OF AMERICA,	)	
DEPARTMENT OF THE TREASURY,	)	
INTERNAL REVENUE SERVICE,	)	
	)	
Defendant and	)	
Counterclaim Plaintiff.	)	
	)	

**UNITED STATES OF AMERICA'S BRIEF IN SUPPORT OF
ITS SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT**

Defendant and Counterclaim Plaintiff United States of America, named and sued as United States of America, Department of Treasury, Internal Revenue Service, submits this brief in support of its Second Motion for Partial Summary Judgment. This brief addresses Counts I, II, and III of the Complaint (Doc. 1), and the United States' Counterclaim (Doc. 4, ¶¶ 74-84),[1] all of which involve whether the Trustee has established that TelexFree, LLC, is entitled to deductions it claimed on its tax returns for the years 2012 to 2014.

[1] Pending cross-motions for partial summary judgment (Docs. 12, 21) address the remaining claims, Counts IV and V of the Complaint.

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II. The Court should hold that the Trustee has not established that TelexFree, LLC, is entitled to deduct the worthless debt allegedly owed to it by its related entity Ympactus as a business bad debt loss pursuant to 26 U.S.C. § 166, because there was no bona fide debt arising from a debtor-creditor relationship. 15

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IV. Based on the disallowances of TelexFree, LLC's claimed deductions for its promises to pay its Participants and for the debt allegedly owed by Ympactus, the Court should grant judgment in favor of the United States on Counts I, II, and III of the Complaint, and on the United States' Counterclaim. 20

Exhibit List

Exhibit No.	**Description of Exhibit**
1	Affidavit of Special Agent John S. Soares in Support of Criminal Complaint, Doc. 2-1, *United States v. Merrill*, Case No. 4:14-cr-40028 (D. Mass. May 9, 2014).
2	Affidavit of Stephen B. Darr in Support of Motion by Chapter 11 Trustee for Entry of Order Finding That Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief, Doc. 623-1, *In re TelexFree, LLC*, Case No. 14-40987 (Bankr. D. Mass. Oct. 7, 2015).
3	Letter from Stephen Darr to IRS Dated Sept. 9, 2016, Attaching Form 1120X for Tax Year 2012 With Original Form 1120 for Tax Year 2012, and Form 1120 for Tax Year 2013.
4	Form 1120 for Tax Year 2014 Dated June 20, 2017.
5	Letter from Stephen Darr to IRS Dated Mar. 7, 2018, Attaching Second Form 1120X for Tax Year 2012.
6	Letter from IRS to Stephen Darr Dated June 17, 2019, Disallowing Claim for Refund Contained in Second Form 1120X for Tax Year 2012.
7	Response by Trustee to United States' Interrogatories.
8	Statutory Notice of Deficiency for Tax Year 2013, Dated Oct. 31, 2017.9
9	Form 1120X for Tax Year 2013 Dated Mar. 7, 2018.
10	Notices of Proposed Adjustment Dated Nov. 7, 2017, Regarding 2014 Advertising Credit Expense, Failure to File Penalties, and Net Operating Loss.
11	Form 1120X for Tax Year 2014 Dated Mar. 7, 2018.
12	Plain English Transcript for TelexFree, LLC, Tax Year 2012.
13	Plain English Transcript for TelexFree, LLC, Tax Year 2013.
14	Plain English Transcript for TelexFree, LLC, Tax Year 2014.

Brief Statement of Issues Presented

In November 2017, the Internal Revenue Service ("IRS") filed a request for payment of administrative expenses in the amount of $15,532,440.39 for 2013, representing the amount of a computer-generated refund erroneously sent to the Trustee for 2013 in December 2016; and in the amount of $53,927,964 for 2014, representing the income tax due based on the IRS's Notices of Proposed Adjustment for that year. (S.O.F. ¶¶ 45–46, 56–57.[2]) The United States also has filed a counterclaim in this adversary proceeding for the recovery of the erroneous refund. (S.O.F. ¶ 46.) Separate from those requests, the IRS also filed a proof of claim for an unsecured priority claim of $285,030,125.64 in additional income taxes for the year 2013; the claim and the administrative expense request for 2013 combined reflect the amount of tax that the IRS determined TelexFree owes for 2013 in its Notice of Deficiency. (S.O.F. ¶¶ 46, 47, 49.) The IRS has disallowed the Trustee's requested refund for 2012, but has not filed any proofs of claim related to that year. (S.O.F. ¶¶ 40–41.) The Trustee has amended each of the preceding returns, but the IRS has not accepted any of those returns for processing and has not adjusted its proof of claim or request for payment of administrative expenses based on any of those returns. (S.O.F. ¶¶ 40, 53, 62.)

The parties already have briefed the questions of, if the IRS's proof of claim and administrative expense requests, and the United States' Counterclaim have merit, what level of priority those claims and requests are entitled to receive. (*See* Docs. 12, 21.) This motion turns to the merits of the IRS's proof of claim and administrative expense requests, which depend on whether the Trustee has established TelexFree, LLC's entitlement to two categories of

[2] "S.O.F." references are references to the United States' Statement of Material Facts in Support of Its Second Motion for Partial Summary Judgment, filed contemporaneously with this motion.

deductions contained on its 2012, 2013, and 2014 returns: deductions in all three years pursuant to 26 U.S.C. § 162 for amounts that TelexFree promised to pay Participants in the Ponzi scheme (both for their "advertising" of the scheme and for recruiting new victims into the scheme); and a deduction in 2013 pursuant to 26 U.S.C § 166 for an alleged debt owed by TelexFree's related Brazilian entity. Although the Court should not need to reach the issue to resolve Counts I, II, and III, and the Counterclaim, in an abundance of caution, this brief also addresses a third category of deduction: a deduction taken on the 2014 amended tax return pursuant to 26 U.S.C. § 165 for a criminal forfeiture by one of TelexFree's principals. Because the Trustee has not established TelexFree's entitlement to any of these three categories of deductions, the Court should enter judgment in favor of the United States on Counts I, II, and III of the Complaint, and the Counterclaim.

Legal Standard

Under Federal Rule of Civil Procedure 56(a), made applicable to this proceeding by Federal Rule of Bankruptcy Procedure 7056, the Court "shall grant summary judgment if [a] movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." A "material" fact is one "that might affect the outcome of the suit under the governing law," and a "genuine" dispute exists "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). "If the evidence is merely colorable, or is not significantly probative, summary judgment may be granted." *Id.* at 249–250 (internal citations omitted). Rule 56 "mandates the entry of summary judgment . . . against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex Corp. v. Cattret*, 477 U.S. 317, 322 (1986).

As to the merits of a suit for refund, "the taxpayer bears the burden of proving the amount he is entitled to recover." *United States v. Janis*, 428 U.S. 433, 440 (1976). In cases alleging an erroneous refund, the United States bears the ultimate burden of proving that a tax refund was erroneous and in what amount. *See United States v. Reagan*, 651 F. Supp. 387, 388 (D. Mass. 1987). The shifted burden of proof with respect to an erroneous refund, however, does not affect "the 'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" *INDOPCO, Inc. v. C.I.R.*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines v. C.I.R.*, 319 U.S. 590, 593 (1943)). "[D]eductions are strictly construed and allowed only 'as there is a clear provision therefor.'" *Id.* (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). In a case involving an erroneous refund, therefore, taxpayers still "must substantiate their entitlement to a claimed credit [or deduction] and are required to retain the records necessary to do so." *United States v. Quebe*, 2019 WL 330852, at *3 (S.D. Ohio Jan. 25, 2019); *see also* 26 U.S.C. § 6001; 26 C.F.R. § 1.6001-1(a), (e).

I. The Court should hold that the Trustee has not established that TelexFree, LLC, is entitled to deduct the promises to pay that it made to Ponzi-scheme Participants pursuant to 26 U.S.C. § 162.

Although the Trustee seeks a declaratory judgment that the "TelexFree Credits"—*i.e.*, TelexFree's promises to pay Ponzi-scheme Participants grossly-inflated returns for the worthless copying and pasting of ads and for recruiting more victims—are deductible pursuant to 26 U.S.C. § 162,[3] the Trustee has failed to meet his burden to establish that TelexFree, LLC, is

[3] On the returns that the IRS audited, the Trustee sought to deduct these promises in the following amounts: $1,175,236 and $9,829,080 for recruiting commissions and advertising credits, respectively, in 2012 (S.O.F. ¶ 36); $622,588,034 and $2,151,645,140 for recruiting commissions and advertising credits, respectively, in 2013 (S.O.F. ¶ 44); and, $2,442,705,606 for advertising credits in 2014 (S.O.F. ¶ 55).

entitled to those deductions. Because TelexFree did not make the promises in carrying on a trade or business, and the promises were not reasonable in amount (and thus were not ordinary and necessary expenses), the Court should determine that the promises were not deductible in any amount. Alternatively, the Court should limit the deduction to the amount of the promises that were paid in cash, the only promises for which TelexFree actually accrued an expense.

A. The Trustee has not established that TelexFree's promises to pay Participants were deductible pursuant to 26 U.S.C. § 162 because the promises were not made in carrying on a trade or business.

Through § 162 of the Internal Revenue Code, Congress has "allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business[.]" 26 U.S.C. § 162(a). The Trustee seeks to have this Court determine that TelexFree was in the "trade or business" of operating a Ponzi scheme (Doc. 1, ¶ 52), but a Ponzi scheme is not a trade or business within the meaning of § 162. As a result, expenses incurred in the course of running the TelexFree Ponzi scheme—including TelexFree's promises to pay its Participants grossly-inflated returns for worthless services or for recruiting new victims—are not deductible pursuant to § 162 in any amount.

Although the TelexFree Ponzi scheme was an income-producing activity, with nearly $360 million in cash receipts in its two-year life span (S.O.F. ¶ 21),[4] it was not a trade or business for the purpose of § 162. Not all income-producing activities are a trade or business; for an income-producing activity to be a trade or business, the taxpayer must have entered into the activity and carried it on "in good faith and for the purpose of making a profit, or in the belief

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[4] The Trustee reported this figure in an affidavit in 2015. The figure may no longer be accurate based on amounts reported in the multiple returns that the Trustee has submitted for each of the years of TelexFree's existence since executing that affidavit.

that a profit can be realized therefrom." *Doggett v. Burnet*, 65 F.2d 191, 194 (D.C. Cir. 1933)[5]; *cf. C.I.R. v. Groetzinger*, 480 U.S. 23, 35 (1987). The taxpayer thus "must possess an actual and honest objective of making a profit," even if making a profit is unlikely or will take significant time to achieve. *Hastings v. C.I.R.*, T.C. Memo. 2002-310 (internal quotation marks omitted). A profit is an "excess of revenues over expenditures." BLACK'S LAW DICTIONARY (11th ed. 2019). Despite the apparent breadth of the trade-or-business test, Ponzi schemes like TelexFree do not meet the test because, by definition, they cannot result in a profit and, indeed, their principals have no intention for the Ponzi scheme to make a profit.

Ponzi schemes are not a trade or business because they cannot result in a profit. A Ponzi scheme is a "fraudulent investment scheme" wherein "[m]oney from the new investors is used directly to repay or pay interest to earlier investors, [usually] without any operation or revenue-producing activity other than the continual raising of new funds." BLACK'S LAW DICTIONARY (11th ed. 2019); *see, e.g.*, *S.E.C. v. SG Ltd.*, 265 F.3d 42, 53 n.3 (1st Cir. 2001); *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 476 B.R. 715, 717 (S.D.N.Y. 2012). Ponzi schemes can never be profitable long term; they collapse once new investments are unable to support the payments promised to earlier investors. *See, e.g.*, *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 232 (2d Cir. 2011) ("Madoff's scheme collapsed when the flow of new investments could no longer support the payments required on earlier invested funds."). Unlike a trade or business for which earning a profit is unlikely or will take years, a Ponzi scheme "is insolvent ab initio, and becomes ever-more so as it persists." Hon. Doroth T. Eiseberg & Nicholas W. Quesenberry, *Ponzi Schemes in Bankruptcy*, 30 TOURO L. REV. 499, 503 (2014)

[5] At the time, the U.S. Court of Appeals for the D.C. Circuit was called the Court of Appeals for the District of Columbia.

("[A]ny Ponzi profits are necessarily fictitious; without any substantial, real business activity, the scheme is incapable of generating true value in excess of contributions."). The First Circuit recognized this feature of Ponzi schemes in litigation arising from the original Ponzi scheme, which Charles Ponzi ran for less than eight months before his fraud collapsed. *Cunningham v. Merchants' Nat'l Bank of Manchester, N.H.*, 4 F.2d 25, 26 (1st Cir. 1925) ("He [Charles Ponzi] was always insolvent; as time went on he became more and more so[.]"). Without any possibility of ever making a profit—because victims are promised outsized returns to secure investments funded by future investors, and only a finite number of victims will ever invest, inevitably leading to collapse—Ponzi schemes fail to meet the test for a trade or business under § 162.

Beyond the inability for a Ponzi scheme to be profitable based on its structure, Ponzi schemes are not a trade or business for the further reason that their principals do not intend to have the Ponzi scheme make a profit. Ponzi scheme principals undoubtedly have the intent to *personally* profit from the Ponzi scheme, as they typically appropriate some or all of the money that victims invest in the scheme. *See* IRS Rev. Proc. 2009-20, § 4.01. In this case, $160 million or more of TelexFree's nearly $360 million in cash receipts was appropriated by two of the three Ponzi scheme principals. (S.O.F. ¶¶ 4, 5, 8, 21, 32, 33; *see also id.* ¶ 30 (describing cashiers' checks totaling nearly $38 million in possession of acting CFO that were seized by federal agents).) An intention of a principal to personally profit, however, is different from the principal having an intention for the Ponzi scheme to result in a profit. A Ponzi scheme principal can personally profit from the scheme by stealing victims' money, but the scheme itself can never profit because its outstanding promises to pay victims always exceeds its revenue. Indeed, principals' thefts from a Ponzi scheme merely increase the insolvency of the scheme by depriving it of funds that already would be insufficient to satisfy outstanding promises to victims, speeding up the scheme's inevitable collapse. Without any ability or intention to turn a profit, Ponzi schemes fail to meet the test for a trade or business.

A Ponzi scheme's inability to result in a profit, and not its illegal nature, is the reason why it is not a trade or business. Unlike a Ponzi scheme, many illegal activities can be a trade or business. *See, e.g.*, *C.I.R. v. Groetzinger*, 480 U.S. 23, 35–36 (1987) (holding that taxpayer's illegal gambling was a business); *C.I.R. v. Sullivan*, 356 U.S. 27, 28–29 (1958) (holding that taxpayer's bookmaking venture was a business); *cf.* 26 U.S.C. § 280E (disallowing deductions for amounts paid or incurred "in carrying on any trade or business . . . [that] consists of trafficking in controlled substances"). Such illegal activities are a trade or business because they have the ability to result in a profit and the person engaging in them intends to turn a profit. By contrast, crimes like embezzlement that involve stealing money from others are not a trade or business. *See, e.g.*, *Yerkie v. C.I.R.*, 67 T.C. 388, 393–95 (1976); *McKinney v. United States*, 1976 WL 1151, at *1–2 (W.D. Tex. 1976); *Hankins v. United States*, 403 F. Supp. 257, 259 (N.D. Miss. 1975), *aff'd*, 531 F.2d 573 (5th Cir. 1976); *cf.* Christine Manolakas, *The Taxation of Thieves and Their Victims: Everyone Loses but Uncle Sam*, 13 Hastings Bus. L.J. 31, 63 (2016 ("[T]he courts and the Service agree that embezzlement does not constitute a business even though the embezzlements are regular and systematic."). When an entity's strategy to make money is, in essence, to steal money received by deceiving investors into believing that they will receive outrageous returns on their investments, the entity cannot ever be profitable. Rather than a legitimate trade or business with some possibility of turning a profit, a Ponzi scheme is more akin to its principal using the corporate form as a cover for the principal's personal hobby; the purpose is not for the scheme to turn a profit, but for the personal aggrandizement of the principal. *See, e.g., Am. Props., Inc. v. C.I.R.,* 262 F.2d 150 (9th Cir. 1958). The fact that certain other illegal activities can be a trade or business does not change the fact that Ponzi schemes fail to meet the test for a trade or business.

Because the TelexFree Ponzi scheme was not a trade or business, the fraudulent promises to pay that TelexFree made to its Participants in the course of carrying on the Ponzi scheme are not deductible pursuant to 26 U.S.C. § 162.

B. The Trustee has not established that TelexFree's promises to pay Participants were deductible pursuant to 26 U.S.C. § 162 because the promises were not ordinary and necessary expenses of a reasonable amount.

If the Court determines that TelexFree, LLC, was engaged in a trade or business within the meaning of § 162 (which it should not), the Court nonetheless should hold that TelexFree cannot deduct its promises to Ponzi-scheme Participants pursuant to § 162 because the Trustee has not established that TelexFree's promises to its Participants were deductible "ordinary and necessary" expenses of a reasonable amount.

Section 162 authorizes the deduction of all "ordinary and necessary" expenses incurred in carrying on a trade or business. 26 U.S.C. § 162(a). Ordinary expenses arise from transactions that are "of common or frequent occurrence in the type of business involved." *Lilly v. C.I.R.*, 343 U.S. 90, 93 (1952). Necessary expenses are ones that are "appropriate and helpful" to the business. *Welch v. Helvering*, 290 U.S. 111, 113 (1933). An expense must be both ordinary and necessary in order to be deductible under § 162. *See id.* at 113 (noting that, to determine deductibility under statutory precursor to § 162, "[t]here is need to determine whether they [the expenses at issue] are both necessary and ordinary"). Ordinary and necessary expenses are subject to the additional requirement that they be reasonable in amount. *See, e.g., C.I.R. v. Lincoln Elec. Co.* 176 F.2d 815, 817 (6th Cir. 1949) ("[T]he element of reasonableness is inherent in the phrase 'ordinary and necessary.'"); *In re Receivership Estate of Indian Motorcycle Mfg., Inc.*, 299 B.R. 8, 27 (D. Mass. 2003). TelexFree's promises to pay its Participants fail to satisfy the last element of ordinary and necessary expenses: they were not reasonable.

If the Court were to find that TelexFree was in the trade or business of operating a Ponzi scheme (which it should not), there are several theories on which its promises to pay Participants might be considered ordinary and necessary expenses, all of which fail because the expenses were not reasonable.

First, if TelexFree's promises to pay Participants are considered a return on Participants' investment in the Ponzi scheme, the promises are not deductible because they were not reasonable. If the Court holds that a Ponzi scheme is a trade or business, it may follow that the Ponzi scheme principals' promises to pay outsized returns to victims are common in the type of business involved (and thus ordinary) and appropriate and helpful to the business (and thus necessary). Like all business expenses, however, the promises still would be subject to the inherent reasonableness requirement in § 162, and the promises would not be deductible because they were not reasonable in amount. *See In re Receivership Estate of Indian Motorcycle Mfg., Inc.*, 299 B.R. at 27. TelexFree received $340 to $360 million (or more) from its Participants and "effectively promised to pay more than $1.1 billion" to them. *S.E.C. v. TelexFree, Inc.*, 301 F. Supp. 3d 266, 268–69 (D. Mass. 2018) (internal quotation marks omitted); S.O.F. ¶ 21. TelexFree promised its Participants returns of between 207% to 265% on their initial investments, with no limit on how many times they could buy into the Ponzi scheme, in exchange for "meaningless" copying and pasting of ads onto websites already saturated with them. (S.O.F. ¶¶ 13–14, 16.) By contrast, the Standard and Poors (S&P) 500 index had annual returns of approximately 13%, 30%, and 11% in 2012, 2013, and 2014, respectively, the years in which TelexFree operated. *See* S&P 500 Historical Annual Returns, MacroTrends, *available at* https://www.macrotrends.net/2526/sp-500-historical-annual-returns. Promises to pay 7 to 24 times the market rate for returns on an investment are not reasonable. The Trustee has not shown that TelexFree had to promise such outrageous returns on investment in order to entice Participants to invest in a bona fide trade or business. A § 162 deduction of TelexFree's promises to pay as returns on investment thus should be denied or limited to the market rate on legitimate investments.

Second, if TelexFree's promises to pay are compensation for Participants' services on behalf of the Ponzi scheme, the fraudulent promises are not deductible because they were not reasonable. Ordinary and necessary business expenses include "a reasonable allowance for salaries or other compensation for personal services actually rendered." 26 U.S.C § 162(a)(1). "[E]xtraordinary, unusual and extravagant amounts" paid "in the guise and form of compensation for [] services, but having no substantial relation to the measure of [those] services and being utterly disproportioned to their value, are not in reality payment for services, and cannot be regarded as 'ordinary and necessary expenses[.]'" *Botany Worsted Mills v. United States*, 278 U.S. 282, 292 (1929). The fact that a business agreed to pay the amounts as compensation does not change that result. *Id.* Here, Participants were promised returns of 207% to 265% of their investments in exchange for copying and pasting ads from a TelexFree website onto other websites identified by TelexFree that were already saturated with the ads. (S.O.F. ¶¶ 13–14.) Participants' promised earnings did not turn on whether the ads that they posted resulted in sales of the VoIP service, and posting ads on websites already saturated with identical ads is a "meaningless exercise" that provided no value. (S.O.F. ¶¶ 13, 17.) A § 162 deduction of

TelexFree's promises to pay as compensation should be limited to the value provided ($0), and thus denied.

Third, if TelexFree's promises to pay are considered to be advertising expenses, the promises are not deductible because they were not reasonable. Advertising expenses are a common ordinary and necessary expense of businesses, but like all such expenses, they must be reasonable in amount to be deductible under § 162. Courts routinely disallow or reduce § 162 deductions for amounts spent on advertising when the purported advertising does not provide value to the business or the amounts spent are unreasonable in relation to the benefit provided to the business. *See, e.g., W.D Gale, Inc. v. C.I.R.*, 297 F.2d 270, 271 (6th Cir 1961) (disallowing "advertising" expense for "operating and maintaining speedboats"); *Bommershine v. C.I.R.*, T.C. Memo. 1987-384 (reducing advertising expenses to reasonable amount); *Brallier v C.I.R*, T.C. Memo 1986-42 (disallowing "advertising" racing expenses because "the amounts deducted were excessive in relation to the purpose served"); *Hahn v. C.I.R.*, T.C. Memo. 1979-429 (disallowing deduction of costs related to horse riding team claimed as "advertising" for medical practice). As stated above, Participants' purported advertising of the TelexFree Ponzi scheme was a meaningless exercise that provided no value. A § 162 deduction of TelexFree's promises to pay as advertising should be limited to the value provided ($0), and thus denied.

Because TelexFree's promises to pay Participants were not ordinary and necessary expenses in reasonable amounts, and any advertising or services provided by Participants had no value, the Court should disallow any § 162 deduction based on those promises.[6]

[6] To the extent that the Trustee believes that the promises to pay, viewed as either compensation or advertising, had some value, the Trustee bears the burden to prove TelexFree's entitlement to the deduction and thus to prove the value provided by the promises. Absent such evidence, the Trustee has not met his burden of proof to establish entitlement to the deductions and the deductions should be disallowed in their entirety.

C. To the extent that the Court holds that TelexFree's promises to pay its Participants are deductible in some amount as ordinary and necessary expenses in carrying on a trade or business, the Court should reduce the claimed deductions to the amounts that TelexFree paid to Participants, which are the only amounts for which TelexFree accrued the expenses.

If the Court determines that TelexFree's promises to pay Participants are ordinary and necessary expenses deductible under § 162 in some amount, the Court should limit the amount of the deduction in each year to the amounts of credits that were exchanged for cash by Participants. The Court thus should limit TelexFree's deductions to $853,892 in 2012, $68,144,795 in 2013, and $83,212,109 in 2014, the amounts that TelexFree paid to Participants in cash for each of the years at issue (S.O.F. ¶¶ 38, 52, 60), because as to the unredeemed credits, TelexFree did not accrue the expenses under the all events test.

The all events test governs in what year an accrual-basis taxpayer, like TelexFree, LLC, can deduct a business expense under § 162(a). *See United States v. Gen. Dynamics Corp.*, 481 U.S. 239, 242 (1987). The all events test is codified in 26 U.S.C. § 461(h)(4), which provides that the test is met "with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy." *See also United States v. Hughes Props., Inc.*, 476 U.S. 593, 600–01 (1986). "[T]he very purpose of the 'all events test' is to make sure that the taxpayer will not deduct expenses that might never occur." *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 410 (5th Cir. 1969). A taxpayer thus cannot deduct an expense based on "a liability that is contingent, or contested." *Gen. Dynamics*, 481 U.S. at 243 (internal citations omitted). "Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year." *Id.* at 243–44; *see also Brountas v. C.I.R.*, 692 F.2d 152, 161–62 (1st Cir. 1982) (holding that all events test was not met as to note, where notice "would effectively be paid only from the proceeds [of goods yet to be delivered]"); *Mooney Aircraft*, 420 F.2d at 410 (affirming disallowance of deduction "because of the inordinate length of time" between purported accrual and when expenses might be paid in future). A taxpayer also may not deduct expenses as to which there is an "extreme improbability that the payments in question would ever be made." *Brainard v. C.I.R.*, 7 T.C. 1180, 1184 (1946).

As to the promises it made to pay Participants that it did not pay, TelexFree did not satisfy the all events test and thus did not accrue those expenses in 2012, 2013, and 2014. The only way that TelexFree could pay Participants in its Ponzi scheme the amounts that they were promised was to continually attract new victims to buy into the scheme, new victims who in turn had to be promised outsized returns. With Participants' payments wholly contingent on future revenues from new victims—and with revenues being drained even faster by the principals' own siphoning off of funds—TelexFree's principals knew that not all Participants would be paid what they had been promised. Indeed, TelexFree's ever-present and continually-increasing insolvency ensured that there was not merely an "extreme improbability" that it would be unable to make all of the payments it had promised to Participants, *Brainard*, 7 T.C. at 1184—it was a literal impossibility that it ever would be able to make all of the payments. Under these circumstances, TelexFree's promises to pay remained too contingent for the all events test to be satisfied until TelexFree actually followed through on its promises and paid Participants the amounts it had promised. *See Brountas*, 692 F.2d at 161–62 (disallowing § 162 deduction for liability on notes when repayment of notes depended on future revenues from goods yet to be produced or delivered, and it remained unknown "whether (and if so, how much of) the liability they represent will ever be paid").

To understand why the all events test is not met, it is helpful to consider an example that does not involve a taxpayer engaged in an illegal activity. Suppose a major automobile manufacturer must enter into a contract for a key component of its automobiles. A single supplier is the only source of the component and demands an outrageous price per component: two times the manufacturer's profit from its most recent fiscal year. The manufacturer's principals know the company can never pay the price demanded, but decide to enter into the contract, thereby promising to pay an amount that they know the manufacturer will never pay. If the manufacturer is an accrual-basis taxpayer, can it take a deduction for the amount it said it would pay but never will? Cases like *Brainard* and *Brountas* explain that the answer is no; liability in such situations is too contingent to satisfy the all events test due to the extreme improbability that the amount owed will ever be paid. But that is in effect what the Trustee asks this Court to do—allow TelexFree to fully deduct promises to pay that it knew it could never keep—and it runs afoul of the purpose of the all events test: to ensure "that the taxpayer will not deduct expenses that might never occur." *Mooney Aircraft*, 420 F.2d at 410. This Court should decline to use this case to create law that holds that a Ponzi scheme can deduct all of its promises to its victims even though it can never (and does not intend to) pay them all.

Because the Trustee has not established that TelexFree, LLC, is entitled to a deduction for its promises to pay Participants pursuant to § 162, the Court should hold that those promises are not deductible in any amount. Alternatively, the Court should limit the deductions to $853,892 in 2012, $68,144,795 in 2013, and $83,212,109 in 2014, the amounts that TelexFree paid to Participants in cash for each of the years at issue (S.O.F. ¶¶ 38, 52, 60), because TelexFree satisfied the all events test only as to the amounts it paid its Participants in cash.

II. The Court should hold that the Trustee has not established that TelexFree, LLC, is entitled to deduct the worthless debt allegedly owed to it by its related entity Ympactus as a business bad debt loss pursuant to 26 U.S.C. § 166, because there was no bona fide debt arising from a debtor-creditor relationship.

On TelexFree, LLC's 2013 amended income tax return, the Trustee claimed a business bad debt deduction of $186,344,898, pursuant to 26 U.S.C. § 166(a), for an allegedly worthless debt owed to TelexFree by its related Brazilian entity Ympactus. (S.O.F. ¶ 44.) The Trustee, however, has not established that the alleged debt owed by Ympactus was a bona fide debt, and thus cannot establish TelexFree's entitlement to a bad debt deduction. The Trustee also has not demonstrated that it reported any income related to that bad debt on any tax return.

Section 166 of the Internal Revenue Code allows taxpayers to take a deduction for business debts that become worthless in a given tax year. *See* 26 U.S.C § 166(a). Business debts are debts "created or acquired (as the case may be) in connection with a trade or business of the taxpayer," or debts "the loss from the worthlessness of which [are] incurred in the taxpayer's trade or business." *Id.* § 166(d)(2). Any debt allegedly owed by Ympactus to TelexFree fails to meet the definition of a business debt because, as explained above in Section I.A, TelexFree did not carry on a "trade or business." Accordingly, any debt that Ympactus owed to TelexFree cannot have been created or incurred in TelexFree's trade or business, and the Trustee is not entitled to deduct the Ympactus debt pursuant to § 166.

The Ympactus debt cannot be deducted pursuant to § 166 for another reason: Section 166 only permits a deduction for an underlying business debt that was "a bona fide debt," 26 C.F.R. § 1.166-1(c), and there was no bona fide debt here. "A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." *Id.* In determining whether a transaction represents a bona fide debt, courts consider all relevant facts and circumstances, including, but not limited to: (1) the existence of notes or written evidence of indebtedness; (2) whether security or collateral was given to the alleged creditor; (3) whether interest was to be paid and was paid; (4) whether there was a fixed repayment schedule and whether payments were made; (5) whether the alleged debtor was undercapitalized at the time of the transaction; and, (6) whether an independent lender would have entered into the transaction. *See Casco Bank & Trust Co. v. United States*, 544 F.2d 528, 532–33 (1st Cir. 1976); *Titmas v. C.I.R.*, T.C. Memo. 1995-267; *cf. LaStaiti v. C.I.R.*, T.C. Memo. 1980-547 ("If petitioner had no reasonable expectation that the business would succeed at the time the [transactions were entered into], then the [transactions] do not result in the creation of bona fide debts."). The Trustee has not established that the Ympactus debt satisfied this test.

The Trustee has not established that there was a bona fide debt owed by Ympactus to TelexFree, LLC. The claimed bad debt deduction is for a net receivable allegedly owed by the Brazilian portion of the TelexFree Ponzi and pyramid scheme (Ympactus) to TelexFree, LLC. Ympactus, like the TelexFree entities, was owned by Wanzeler, Merrill, and Costa, who ran it in the same way that they ran TelexFree in the United States: the entities had the same structure and terminology, and used the same website and database. (S.O.F. ¶¶ 4, 5, 7, 8, 22–27.) The Trustee has not produced evidence of any sale that produced an account receivable that was previously reported on a tax return as income; evidence of a loan by TelexFree, LLC, to Ympactus; evidence of security or collateral granted by Ympactus to TelexFree, LLC; or evidence of a set repayment schedule with interest, or of payments of principal or interest being made on that schedule.[7] Ympactus was necessarily undercapitalized at the time it allegedly incurred a debt to

[7] To the extent that the Trustee has any such evidence, the Trustee should have produced that evidence with its Fed. R. Civ. P. 26(a) initial disclosures or as a supplement to those disclosures. The Trustee did not do so.

TelexFree, LLC, because, like TelexFree, it was a Ponzi and pyramid scheme (S.O.F. ¶¶ 24, 26), and Ponzi schemes begin insolvent and become increasingly insolvent the longer that they exist. *See, e.g.*, *Cunningham v. Merchants' Nat'l Bank of Manchester, N.H.*, 4 F.2d 25, 26 (1st Cir. 1925). No independent lender would have loaned Ympactus $186,344,898, or otherwise extended it that amount of credit. An independent lender would have reviewed Ympactus's books and records prior to lending it nearly $200 million and, after realizing that the overwhelming majority of Ympactus's revenue derived from people buying into the scheme and not from its VoIP service (S.O.F. ¶¶ 11–12, 24, 26), would not have lent Ympactus the money. The Ympactus net receivable is not a bona fide debt; it was a phony transaction that the TelexFree principals purported to have the Brazilian and United States' portions of their Ponzi and pyramid scheme enter into together. The Trustee has not proven otherwise and thus has not established TelexFree, LLC's entitlement to the $186,344,898 bad debt deduction claimed on the 2013 income tax return.

Because the Trustee has not established TelexFree, LLC's entitlement to deduct $186,344,898 allegedly owed to TelexFree by its related Brazilian entity as a bad business debt pursuant to § 166, the Court should hold that TelexFree cannot deduct $186,344,898 from its 2013 income.

III. If the Court reaches the issue, the Court should hold that the Trustee has not established that TelexFree, LLC, is entitled to deduct the value of assets seized by law enforcement as a loss pursuant to 26 U.S.C. § 165, because § 162(f)(1) bars the deduction of fines and similar penalties, including criminal forfeitures.

On TelexFree, LLC's amended tax return for 2014, the Trustee claimed a deduction of $148,000,000 pursuant to 26 U.S.C. § 165, which arises almost entirely from property seized by law enforcement and then forfeited by Merrill as part of his guilty plea and conviction. (S.O.F. ¶¶ 30, 32, 61.) The Court need not reach the issue of the deductibility of this criminal forfeiture because the $148 million deduction was not included on the 2014 return that was processed by the IRS and that forms the basis of the IRS's request for payment of administrative expenses for the 2014 tax year, the request for payment that (along with the IRS's claim and request for payment of administrative expenses for 2013) forms the subject of Count III of the Complaint. (S.O.F. ¶¶ 55–57; Compl., Doc. 1, at 16–17 (¶¶ 64, 3).) If the Court were to reach the issue of the deductibility of the criminal forfeiture despite it not forming part of the disputed IRS request for payment of administrative expenses, however, the Court should hold that the Trustee has not established that the approximately $148 million criminal forfeiture is deductible pursuant to § 165.

TelexFree cannot deduct the $148 million forfeited by Merrill as part of his criminal sentence because a statutory prohibition bars the use of § 165 to deduct criminal forfeitures. Section 165 allows "as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." 26 U.S.C § 165(a). Section 165, like all deductions contained in the "Normal Taxes and Surtaxes" chapter of the Internal Revenue Code, is subject to the statutory prohibition on deducting fines and similar penalties contained in § 162(f)(1). Section 162(f)(1) provides that, except for amounts that constitute restitution or that are paid to come into compliance with a violated law (neither of which apply here), "no deduction otherwise allowable shall be allowed under this chapter [Normal Taxes and Surtaxes] for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation or any law or the investigation or inquiry by such government or entity into the potential violation of any law." *Id.* § 162(f)(1). Accordingly, "any fine or similar penalty paid to . . . [t]he government of the United States," including amounts paid "pursuant to a conviction or a plea of guilty . . . for a crime (felony or misdemeanor) in a criminal proceeding," is not deductible under § 165. 26 C.F.R. § 1.162-21(a)(1), (b)(1)(i).

Criminal forfeitures, like Merrill's forfeiture of approximately $148 million as part of his guilty plea and criminal sentence, are a fine or similar penalty for the purpose of § 162(f)(1), and thus ineligible for deduction under § 165. The courts to have considered the question have uniformly held that criminal forfeitures are a fine or similar penalty and thus are not deductible under § 165. *See Nacchio v. United States*, 824 F.3d 1370, 1378–79 (Fed. Cir. 2016); *King v. United States*, 152 F.3d 1200, 1201–02 (9th Cir. 1998); *Wood v. United States*, 863 F.2d 417, 420–22 (5th Cir. 1989); *cf. Hackworth v. C.I.R.*, 155 F. App'x 627, 630 (4th Cir. Nov. 16, 2005) (relying on frustration-of-public-policy doctrine described in footnote 8 to reach same conclusion).[8] Criminal forfeitures are a mandatory part of a convicted criminal defendant's sentence when the defendant is convicted of a federal offense that gives rise to forfeiture. 28 U.S.C. § 2461(c). As a mandatory part of the defendant's sentence, a criminal forfeiture is punitive in nature. *See Nacchio*, 824 F.3d at 1378–79; *Wood*, 863 F.2d at 421. A criminal forfeiture serves a different purpose from restitution, which "functions to compensate the victim, whereas forfeiture acts to punish the wrongdoer." *United States v. Blackman*, 746 F.3d 137, 143 (4th Cir. 2014) (reversing district court order that denied government's request for forfeiture when restitution had been ordered, and remanding with direction to enter forfeiture money judgment). As § 162(f) itself recognizes, restitution may be deductible, but criminal forfeiture is

[8] Section 162(f) codifies part of the frustration-of-public-policy doctrine that prohibits taxpayers from deducting losses, like those from law enforcement seizures or criminal forfeitures, the deduction of which would frustrate "sharply defined national or state policies proscribing particular types of conduct." *Tank Truck Rentals, Inc. v. C.I.R.*, 356 U.S. 30, 33-34 (1958); *Fuller v. C.I.R.*, 213 F.2d 102, 105 (10th Cir. 1954); *see also Thrower v. C.I.R.*, T.C. Memo. 2003-139, *2.

not. 26 U.S.C. § 162(f)(2); *see Nacchio,* 824 F.3d 1380 (distinguishing deductible restitution in criminal sentence, which was to compensate victim and not paid to government, from non-deductible forfeiture). Merrill's forfeiture of approximately $148 million as part of his guilty plea and criminal conviction is a forfeiture and thus non-deductible. Even if the Government decides to use the forfeited funds to compensate TelexFree victims (*see* S.O.F. ¶ 61), its decision to use the forfeited funds in that way does "not transform the character of the forfeiture so that it was no longer a 'fine or similar penalty' under § 162(f)." *Nacchio,* 824 F.3d at 1380.

Because Merrill's forfeiture was a non-deductible fine or similar penalty, the Trustee cannot take a § 165 loss deduction for that forfeiture on TelexFree, LLC's 2014 amended tax return.

IV. Based on the disallowances of TelexFree, LLC's claimed deductions for its promises to pay its Participants and for the debt allegedly owed by Ympactus, the Court should grant judgment in favor of the United States on Counts I, II, and III of the Complaint, and on the United States' Counterclaim.

This Section explains how the arguments in Sections I, II, and III, above, resolve Counts I, II, and III of the Complaint, and the United States' Counterclaim.

Through Count I, the Trustee seeks a declaratory judgment that "the TelexFree Credits" (*i.e.*, the amounts that TelexFree promised its victims it would pay them as part of the Ponzi scheme for both "advertising" the scheme and recruiting new victims) claimed on its amended tax return for 2012 and its tax returns for 2013 and 2014 "are ordinary and necessary expenses of the operation of TelexFree and are deductible[] pursuant to 26 U.S.C. § 162. (Compl., Doc. 1, at 17 (¶ 1 of requested relief).) The Trustee also appears to seek, through Count I, a declaratory judgment that TelexFree is entitled to deduct on its 2013 tax return, pursuant to 26 U.S.C. § 166, the worthless debt allegedly owed to it by Ympactus. (*Id.* ¶ 56.) The argument in Sections I and II resolve Count I of the Complaint by explaining the reasons why the Trustee has failed to meet his burden to show that TelexFree is entitled to take those deductions. The Court thus should deny the relief in Count I, and hold that TelexFree's promises to pay its Participants are not deductible pursuant to § 162 and the worthless debt allegedly owed to it by Ympactus is not deductible pursuant to § 166.

Through Count II, the Trustee seeks a declaratory judgment that "TelexFree had no taxable income for the tax years 2012, 2013 and 2014 and is entitled to a tax refund of $886,700 for the tax year 2012" and to retain the erroneous refund of amounts paid toward its 2013 taxes. (Compl., Doc. 1, at 17 (¶ 2).) As to the 2012 refund claim, $692,854 of the $886,700 reflects the amount of tax that TelexFree paid for 2012 and that the Trustee sought to have refunded via its amended tax return; the Trustee describes the remaining $193,847 as "interest and penalties." (*Id.* ¶ 32.) Through Count III, the Trustee seeks a declaratory judgment disallowing the IRS's filed proofs of claim and requests for payment. (*Id.* at 17 (¶ 3).) Counts II and III both involve the question of whether the IRS correctly disallowed in full the deductions for promises TelexFree made to Participants in 2012, 2013, and 2014, and for the allegedly worthless Ympactus debt in 2013. Sections I and II are both relevant to this question. Section III should not be relevant because it relates to a deduction that the Trustee failed to include on the 2014 return that is the subject of the IRS's claim for administrative expense. But to the extent that the Court deems it appropriate to consider that newly-presented deduction, Section III also would be relevant to the resolution of Counts II and III. If the arguments in Sections I, II, and III are accepted, the Court should hold that the Trustee has not established that TelexFree is entitled to deduct its promises to pay its Participants, the allegedly worthless Ympactus debt, or the $148,000,000 criminal forfeiture (as well as for any net operating loss deduction that would arise from the other deductions offsetting taxable income). Without those deductions, TelexFree is not entitled to a refund for 2012 and it owes income taxes of $300,507,248 and $53,927,964 for 2013 and 2014, respectively. (S.O.F. ¶¶ 40 (Disallowance of 2012 Claim for Refund based on disallowed on gross credit liability accrual and net operating loss), 48 (Notice of Deficiency disallowed bad debt, commissions, and advertising credits deductions, and calculated resulting income tax at $300,507,248 for 2013), 56 (Notice of Proposed Adjustment disallowed advertising credits expense and net operating loss, and calculated resulting income tax at $53,927,964 for 2014).) And because TelexFree owes income tax of $300,507,248 for 2013, far more than the $15,532,440.39 refund erroneously generated by a computer and issued to the Trustee, the Trustee is indebted to the United States in the amount of that erroneous refund. *See United States v. Reagan*, 651 F. Supp. 387, 388 (D. Mass. 1987) The Court thus should grant summary judgment in favor of the United States on Counts II and III of the Complaint and on the United States' Counterclaim by allowing the IRS's proof of claim and its request for payment of administrative expenses as filed, denying any turnover requests or claims for refund made by the Trustee, and entering a money judgment in favor of the United States and against the Trustee in the amount of $15,532,440.39, plus statutory additions including interest from and after December 26, 2016, for the erroneous refund that was issued to the Trustee related to TelexFree, LLC's federal income taxes for the tax year 2013.

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WHEREFORE, the United States of America respectfully requests that the Court grant the United States' second motion for partial summary judgment, and grant judgment in its favor on Counts I, II, and III of the Complaint, and on its Counterclaim.

Dated: September 20, 2019

Respectfully submitted,

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