Docket #0065 Date Filed: 11/4/2019

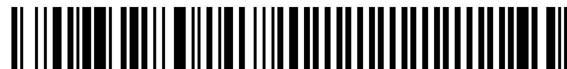
UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS

In re: TELEXFREE, LLC, TELEXFREE, INC. and TELEXFREE FINANCIAL, INC., Debtors.	Chapter 11 Cases 14-40987-MSH 14-40988-MSH 14-40989-MSH Jointly Administered
STEPHEN DARR, AS HE IS THE TRUSTEE OF THE CHAPTER 11 ESTATES OF EACH OF THE DEBTORS, Plaintiff, v. UNITED STATES OF AMERICA, DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, Defendant.	Adversary Proceeding No. 18-4091

OPPOSITION BY CHAPTER 11 TRUSTEE TO UNITED STATES OF AMERICA'S SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT

Stephen B. Darr, the Chapter 11 Trustee ("Trustee") of the bankruptcy estates ("Estates") of TelexFree LLC, TelexFree Inc., and TelexFree Financial Inc. (collectively, "TelexFree") respectfully submits this opposition to the Second Motion by the United States of America (the "Service") for Partial Summary Judgment on Counts I, II, and III of the Complaint (the "Service Motion").[1] The Service Motion should be denied and, pursuant to Federal Rule of

[1] The Trustee and the Service had earlier filed cross-motions for summary judgment on Counts IV and V of the Complaint. Count IV seeks a declaration that if the Service has a claim for unpaid taxes for 2013, such claim constitutes a prepetition unsecured claim. Count V seeks a declaration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Civil Procedure ("FRCP") 56(f), incorporated by Federal Rule of Bankruptcy Procedure ("FRBP") 7056, judgment should enter for the Trustee on each of the Counts of the Complaint.

Overview

TelexFree operated a Ponzi and pyramid scheme using a multi-level marketing ("MLM") structure. A Ponzi scheme promises unrealistic returns to investors which can only be met by inflows from new investors. An MLM, also referred to as network marketing or referral marketing, is a direct sales strategy whereby independent sales agents can earn commissions for sales they generate and for the sales generated by other persons that they recruit. An MLM business can be legitimate, provided that its revenues are predominantly from the sale of the product. In an MLM, participants are promised and paid commissions for promoting the product and for recruiting others to do so.

TelexFree is distinguishable from a legitimate MLM because the sales of its ostensible product, a VoIP phone service, were insignificant in relation to the sale of membership plans. In order to induce persons ("Participants") to purchase membership plans and to recruit others to do so, TelexFree by necessity promised substantial returns to its Participants. Because of these promised returns, TelexFree grew exponentially, generating more than $3,000,000,000 from the sale of membership plans.

The Service does not dispute that the expenses incurred by TelexFree in promoting and expanding its business (the "Promotional Expenses") are ordinary and necessary expenses of TelexFree's business. Without any factual or legal support, however, the Service arbitrarily determined that the Promotional Expenses are "unreasonable" in amount and disallowed their

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that if the Service has a claim for unpaid taxes for 2014, such claim constitutes a prepetition unsecured claim. Those cross-motions are currently under advisement.

entire deduction. In doing so, the Service failed to recognize that an essential element of a Ponzi and pyramid scheme is the promise of substantial returns in order to induce participants to join the scheme and to recruit others to do so.

There are no facts or law to support the Service's contention that TelexFree was not engaged in a trade or business, because even businesses that lose money or are illegal may still deduct expenses associated with conducting their businesses. TelexFree had no business other than the sale of membership plans. It generated substantial income each year, reported a profit in the first year of its operation and, under well-established law, the ordinary and necessary expenses in conducting its business are fully deductible.

The Service's disallowance of the bad debt loss sustained by TelexFree on account of the Ympactus receivable is similarly unsupported by the facts and law. TelexFree reported income from Ympactus on its returns as a receivable, and that receivable became uncollectible in 2013 when Ympactus was seized and shut down by the Brazilian government. Accordingly, TelexFree is entitled to take a deduction for this previously reported income.

The Service disallowance of the casualty loss sustained by TelexFree as a result of the seizure of its property by the government is similarly baseless. TelexFree has not been convicted of any crime, nor assessed any criminal fines or penalties, and the seized funds will be used to pay restitution to net loser Participants. Therefore this expense is fully deductible as a casualty loss.

Accordingly, the Service Motion should be denied. Because there are no disputed material facts and the Trustee is entitled to judgment as a matter of law, the Court should enter judgment in his favor in accordance with FRCP 56(f), incorporated by FRBP 7056.

Legal Standard for Summary Judgment

Summary judgment is only appropriate when the record reveals both that there is no genuine dispute as to any material fact, and that the moving party is entitled to judgment as a matter of law. FRCP 56(a); FRBP 7056. As the moving party, the Service has the burden of demonstrating that there is no genuine issue of any fact essential to the Service's asserted basis for disallowance of the Trustee's claimed deductions. The Service must also establish that, based on those undisputed facts, it is entitled to judgment as a matter of law. A failure by the Service to offer affirmative proof demonstrating that there is no genuine issue of fact and that it is entitled to judgment as a matter of law requires denial of the Service Motion. Where, as here, the uncontested facts establish that the Trustee is entitled to judgment as a matter of law, the Court should grant summary judgment for the Trustee pursuant to FRCP 56(f).

I. Argument

A. The burden of proof rests with the Service to substantiate its disallowance of TelexFree's deductions.

While the taxpayer typically has the burden to prove the allowance of a deduction, there are two exceptions, both present in this case, in which the burden to prove disallowance of a deduction is placed upon the Service.[2]

First, the burden shifts to the Service to sustain its disallowance of deductions if the following conditions are met:

(i) The taxpayer is a corporation with a net worth that did not exceed $7,000,000 and had fewer than 500 employees at the time the action was commenced; and

[2] The Service bears the burden of establishing that a tax refund was erroneous and in what amount. *See United States v. Reagan*, 651 F. Supp. 387 (D. Mass. 1987); *Soltermann v. United States*, 272 F.2d 387 (9th Cir. 1959); *United States v. Wood*, 79 F.2d 286 (3d Cir. 1935).

(ii) The taxpayer has produced credible evidence to support its position, established that it has complied with the Internal Revenue Code ("IRC") substantiation and recordkeeping requirements, and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings and interviews.

See 26 U.S.C. §7491(a)(1), (2); 26 U.S.C. §7430(c)(4)(A)(ii); 28 U.S.C. §2412(d)(2)(B)).[3]

TelexFree did not have a net worth of more than $7,000,000, nor did it have more than 500 employees at the time this action was commenced. *Trustee's Statement of Undisputed Facts in Support of his Opposition by Chapter 11 Trustee to United States of America's Second Motion for Partial Summary Judgment* ("SUF") at ¶4. The Service does not contest that TelexFree maintained accurate books and records reflecting income and expenses arising from both direct transactions and triangular transactions involving the sale of membership plans and that such income and expenses were reported on TelexFree's returns. SUF, at ¶25. TelexFree's books and records reflected income from Ympactus in 2012 and 2013. This income was reported on TelexFree's tax returns, along with a deduction for the income in 2013 when the Ympactus receivable became uncollectible. SUF, at ¶79-82. The value of TelexFree's assets seized by the federal government in 2014 is a matter of public record. *See United States v. James Matthew Merrill, et al.*, 4:14-cr-40028-TSH, in the United States District Court for the District of Massachusetts.

[3] While the IRC does not define "credible evidence", the Conference Committee Report, *H. Conf. Rep*. 105-599, at 240-241 (1998), 1998-3 C.B. 747 provides that "credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted…If after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof."

The Trustee has fully cooperated with the Service's information requests. The Trustee provided detailed substantive responses to each of the notices of disallowance of deductions issued by the Service. SUF, at ¶38, 43, 48. The Trustee has responded to informal informational requests of the Service and has produced the expert report of Thomas Greenaway to identify the deductions taken, the basis therefor, and the records substantiating such deductions. SUF, at ¶50. The Trustee has fully cooperated with all discovery requests by the Service during the course of this adversary proceeding, including making the Trustee and Mr. Greenaway available for depositions, responding to interrogatories, and participating in multiple conferences with the Service.

Second, the burden is imposed on the Service to sustain the disallowance of a taxpayer's deductions where the taxpayer demonstrates that the disallowance by the Service is arbitrary, capricious, or excessive. *See Helvering v. Taylor*, 293 U.S. 507, 515 (1935). The Service's actions are arbitrary where the disallowance of deduction is "naked" and "utterly without foundation". *United States v. Janis*, 428 U.S. 433, 442 (1976).

As set forth herein, the Service's disallowance of one hundred percent (100%) of the deductions for the Promotional Expenses, the Ympactus bad debt loss, and the casualty loss was both arbitrary and excessive. Accordingly, as to each of the claimed deductions, the Service has the burden of establishing that these amounts are not deductible. *Clark v. Commissioner*, 266 F.2d 698, 707 (9th Cir. 1959).

B. TelexFree was engaged in a trade or business and, therefore, it is entitled to deduct its ordinary and necessary business expenses.

A taxpayer is entitled to a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on its trade or business. 26 U.S.C. §162(a). A taxpayer qualifies as being engaged in a trade or business when it pursues that business on a

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full-time basis, in good faith, and with regularity, for the production of income or profit and not as a mere hobby. *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

A for-profit corporation is normally deemed to be engaged in a trade or business, and all corporate activities are assumed to be business activities. *General Counsel Memorandum* ("GCM") 37071 (Mar. 30, 1977).[4] A basic characteristic of corporations is that the profit-motivated activities in which they engage are considered to be trade or business activities." GCM 37513 (Apr. 25, 1978), at *13. The Service almost always treats corporations as having a profit motive. GCM 37513 at *15. "There have been no section 162 cases involving corporate taxpayers…where deductions have been challenged on the theory that the profit-making activity in which they were incurred did not constitute a trade or business." *Id*. (emphasis added).

To be engaged in a trade or business, the taxpayer need only have initiated or conducted the enterprise with the intention of making a profit or producing income. *See International Trading Co. v. Commissioner*, 275 F.2d 578 (7th Cir. 1960); *Groetzinger*, 480 U.S. at 35 (primary purpose for engaging in activity must be for income or profit); *Doggett v. Burnet*, 65 F.2d 191 (Cir. D.C. 1933)(taxpayer need not have reasonable expectation of profit). The determination of whether something constitutes a trade or business should be liberally construed in favor of the taxpayer. *Doggett*, 65 F.2d at 193. The real test is whether an operation was carried on as a business for gain or, alternatively, was implemented for recreation or the pleasure of its owner. *Id.* at 194.

The "good faith" requirement for a trade or business is satisfied if there is an honest intention. Good faith does not require that the taxpayer must have intended to produce the

[4] GCM's constitute the "working law" of the Service, and are useful to courts and taxpayers as a research tool providing a substantially consistent interpretation of the IRC. *Tupper v. United States*, 134 F.3d 444 (1st Cir. 1998). GCM's do not establish precedent. *Id.*

income by honest means. The rationale supporting this principle is that federal tax law is designed to collect taxes based upon net income, not to punish wrongdoers. *Commissioner v. Heininger*, 320 U.S. 467 (1943)(purpose of tax law is not to penalize illegal business by taxing gross income, rather than net income); *Commissioner v. Sullivan*, 356 U.S. 27 (1958)(if illegal businesses are to be taxed on gross receipts, while all other businesses are taxed based on net income, that is a decision to be made by Congress). Many income-producing businesses that engage in illegal activities are permitted to take deductions for expenses incurred in pursuing these activities. SUF, at ¶99.

The requirement of a "full-time activity" means that the taxpayer must be involved in the activity with continuity and regularity. *Groetzinger*, 480 U.S. at 34. This requirement is intended to distinguish a trade or business from an activity that is sporadic, a hobby, or pursued for amusement. *Id.* As noted above, the full-time activity of the taxpayer need not be a legal enterprise to qualify as a trade or business. *Commissioner v. Tellier*, 383 U.S. 687 (1966).

TelexFree satisfies each of the criteria to be a trade or business. TelexFree, a limited liability company, is taxed as a subchapter C corporation. TelexFree engaged in the sale of membership plans on a full-time basis. It retained multiple employees, rented office space, and contracted with vendors and Participants. SUF, at ¶13, 14. TelexFree engaged in a good-faith and concerted effort to generate income or profit. TelexFree generated substantial gross income in each year of operations. In 2012, TelexFree had gross income of $18,220,915, in 2013 it had gross income of $1,173,886,556, and in 2014 it had gross income of $2,067,416,945. SUF, at

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¶31, 35, 45. TelexFree reported a profit of more than $13,000,000 in 2012 on its second amended return. SUF, at ¶31.[5]

There is no support for the Service's position that since a Ponzi and pyramid scheme is destined to fail, none of its expenses are deductible.[6] While accepting that TelexFree generated $3,000,000,000 in income, the Service disallowed substantially all of the expenses and filed administrative and priority claims against the Estates in the aggregate amount of more than $400,000,000. SUF, at ¶40, 42. The Service's position is arbitrary and without foundation.

Unable to cite to any case supporting its position that all Ponzi and pyramid scheme businesses are *per se* disqualified from deducting expenses incurred in their businesses, the Service relies upon cases where the taxpayer's deductions are denied because it was not engaged in a full-time trade or business. *See, e.g., Yerkie v. Commissioner*, 67 T.C. 388, 393-95 (1976)(embezzlement was not a trade or business because the taxpayer was a full-time salaried employee and embezzled funds as a result of his activities in this capacity; taxpayer could not take a business loss deduction under Section 165 of the IRC for repayment of embezzled funds); *Hankins v. United States*, 403 F. Supp. 257, 259 (N.D. Miss. 1975), aff'd 531 F.2d 573 (5h Cir. 1976)(taxpayer was not engaged in a trade or business when he embezzled funds from his employer); *McKinney v. United States*, 1976 WL 1151, at *1-2 (W.D. Tex. 1976)(an isolated or

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[5] On September 9, 2013, TelexFree, LLC filed an original federal income tax return, Form 1120, for the 2012 tax year, reporting tax of $686,121. TelexFree, LLC made payments to the Service of $706,713.79 and $179,986.86 on October 16, 2013 and December 12, 2013, respectively, for the 2012 tax year, of which $686,121 is tax and $200,579 is penalties and interest. The Trustee filed amended returns for 2012 on September 9, 2016 and March 7, 2018 requesting a refund of amounts paid for 2012. The Service has disallowed the refund request. SUF at ¶27-31.

[6] The Service's argument that TelexFree was not engaged in a trade or business is of recent vintage. The Service did not assert that argument in any of the prelitigation notices as a reason why the Promotional Expenses should be disallowed.

occasional activity or transaction is not sufficient to be a trade or business; taxpayer's true trade or business was as an employee of the Texas Employment Commission). These cases are not applicable because TelexFree was engaged in the full-time business of selling membership plans.

C. The Promotional Expenses are ordinary and necessary costs of operating the TelexFree's business and are deductible in the years incurred.

The Promotional Expenses incurred by TelexFree for the Participants' promotional activities of posting advertisements, recruiting, and selling VoIP plans are an ordinary and necessary expense of operating its business. SUF, at ¶67. Accordingly, the Promotional Expenses are deductible. 26 U.S.C. §162.

A taxpayer engaged in a trade or business may take a deduction for expenses that are ordinary and necessary in carrying on its business. 26 U.S.C. §162. An expense is ordinary if it arises from transactions "of common or frequent occurrence in the type of business involved," *Lilly v. C.I.R.*, 343 U.S. 90, 93 (1952), or has a "reasonably proximate", and not remote, relationship to the operation of the taxpayer's trade or business. *Boomershine v. Commissioner*, 1987 Tax Ct. Memo LEXIS 382 (U.S.T.C. 1987) at *7; *Hahn v. Commissioner*, 1979 Tax Ct. Memo LEXIS 99 (U.S.T.C. 1979). The expense need not recur with regularity but need only be typical in the context of the business operated by the taxpayer. *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

The term "necessary" imposes on the taxpayer "only the minimal requirement that the expense be 'appropriate and helpful' for the development of the [taxpayer's] business". *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 86 (1992), *citing Commissioner v. Tellier*, 383 U.S. 687, 689 (1966)(emphasis added); *see also Welch v. Helvering*, 290 U.S. 111, 113 (1933)(court should be slow to override the judgment of the taxpayer as to the necessity of a

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business expense). The lawfulness of the enterprise does not affect the deductibility of expenses. The federal income tax is a tax on net income, not a sanction against wrongdoing. *Sullivan v. Commissioner*, 356 U.S. 27 (1958); *Tellier*, 383 U.S. at 691 (1966)(legal expenses incurred in defending illegal activity were deductible because such expense was not specifically disallowed by the IRC).

The deductibility of an expense requires consideration of the specific facts of each case in the context of the taxpayer's business. *Indopco,* 503 U.S. at 86; *Lilly v. Commissioner*, 343 U.S. 90 (1952). In *Lilly*, the taxpayer, a retail optical business, claimed a business deduction for payments made to referring physicians in an amount equal to one-third of the sales price of glasses sold to their patients. The Service disallowed the deduction, and the Tax Court sustained the Service's disallowance on the ground that the payments to the doctors were contrary to public policy. 14 T.C. 1066. The Court of Appeals affirmed the Tax Court. 188 F.2d 269. On further appeal, the United States Supreme Court reversed and upheld the deductibility of the expense. In finding for the taxpayer, the Supreme Court evaluated the deductions in light of the business of the taxpayer and the customary and usual practices of that business, concluding that the payments to physicians were ordinary in the optical industry and necessary to receiving referrals from the physicians. The Supreme Court noted that "to say that this course of conduct and the expenses which it involved were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world." Lilly, 343 U.S. at 94. The Supreme Court further observed:

> Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary.
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> *Id*, 343 U.S. at 94, f/n 4 (1952).

While the Supreme Court did not condone the practice of paying referral fees for patients, the Supreme Court found that there was nothing in the statute or regulations prohibiting the deduction of an ordinary and necessary business expense on the grounds that it might violate or frustrate "public policy". *Id*. at 94.

The Promotional Expenses are ordinary and necessary expenses incurred in the operation of TelexFree's Ponzi and pyramid scheme which, like other Ponzi and pyramids schemes, relied upon the promise of substantial returns to its Participants as an inducement to purchase membership plans and to recruit others to do so. SUF, at ¶ 65. TelexFree's business was structured as an MLM, where Participants were incentivized and rewarded to recruit other Participants and thereby expand the pyramid. The Participants were referred to as promoters in TelexFree's membership contract. SUF, at ¶ 5. The TelexFree contract with Participants detailed how Participants could earn credits, and the credits were posted to Participant's User Accounts as they were earned. SUF, at ¶ 6-7, 9. Once earned, the credits could be redeemed for cash or for the purchase of additional membership plans (SUF, at ¶ 10, 11) and, in fact, the credits were redeemed nearly as fast as they were issued, as set forth below:

Credits Issued by TelexFree and Redeemed by Participants

Year	**Issued**	**Redeemed**
2012	$ 4,261,846	$ 4,261,846
2013	$ 972,955,648	$ 911,620,550
2014	$2,442,705,606	$1,950,007,485

SUF, at ¶12.

As a result of the incentives established by TelexFree, its business grew exponentially over a three-year period, engaging more than 1,000,000 Participants who opened more than 11,000,000 User Accounts. It generated aggregate sales during this period in excess of

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$3,000,000,000, making it one of the largest Ponzi and pyramid schemes in United States history. SUF, at ¶3, 8. Because of these incentives, Participants recruited family members, neighbors, and co-workers, through the internet and by word-of-mouth. As in the *Lilly* case, without the Promotional Expenses, there would have been no income and therefore no tax. Lilly, 343 U.S. at 94, f/n 4; SUF, at ¶ 65.

Section 162 of the IRC governing deduction of business expenses incurred by a taxpayer requires only that the expense be ordinary and necessary. 26 U.S.C. §162. Section 162(a)(1), by contrast, requires that deduction for salaries and other compensation for personal services be reasonable in amount. 26 U.S.C. §162(a)(1). Imposing a reasonableness requirement for the deduction of all business expenses, in contravention of the clear language of the statute, would impose an unfair burden upon taxpayers engaged in a trade or business and would result in subjective disputes as to the deductible amounts for individual expense items.

The cases cited by the Service in support of its argument that the Promotional Expenses should be denied as unreasonable are wholly distinguishable. The reasonableness of expenses incurred by the taxpayer were not at issue in *In re Receivership of Indian Motorcycle Mfg.*, 299 B.R. 8 (D. Mass. 2003). Rather, the question was whether those expenses, amounts paid by the taxpayer on behalf of another corporation, were ordinary and necessary expenses of the taxpayer's business. *Id.* Similarly, the Service cites to cases that are inapposite in that they involve expenses incurred by a corporation that were not ordinary and necessary because they were for the personal enjoyment of the principal. For example, in *W.D. Gale, Inc. v. Commissioner*, 297 F.2d 270 (6th Cir. 1961), the court disallowed expenses for the operation of speedboats that were for the personal pleasure of the principal. In *Brallier v. Commissioner*, 1986 Tax Ct. Memo LEXIS 568 (U.S.T.C. 1986), the court partially allowed an advertising

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expense for the cost of automobile racing performed by the corporation's principal, with the balance of the expense disallowed as being for the personal benefit of the principal; *see also Boomershine v. Commissioner*, 1987 Tax Ct. Memo LEXIS 382 (U.S.T.C. 1987)(advertising costs for automobile racing partially allowed); In *Hahn v. Commissioner*, 1979 Tax Ct. Memo LEXIS 99 (U.S.T.C. 1979), the court disallowed a deduction of the taxpayer-physician for costs associated with his equestrian hobby. *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929) was a case involving disallowance of excessive compensation to directors of the taxpayer. As noted above, a reasonableness standard is imposed upon compensation for personal services to guard against the payment of disguised dividends to principals of a taxpayer. While the court in C*ommissioner v. Lincoln Electric Co.*, 176 F.2d 815 (6th Cir. 1949) held that there was an element of reasonableness inherent in the phrase "ordinary and necessary", the authorities it cited do not stand for that proposition. *See* dissenting opinion, 176 F.2d at 819.

The Trustee has established that the Promotional Expenses are ordinary and necessary. The Service has the burden to prove that the Promotional Expenses claimed by TelexFree are not reasonable. The Service has offered no affirmative evidence as to the unreasonableness of the Promotional Expenses. The Service's revenue agent assigned to this case has no prior experience in the taxation of Ponzi and pyramid schemes, has no understanding of the intricacies of the TelexFree business, and conducted no investigation of TelexFree's operations. SUF, at ¶45-47. The Service has produced no expert report or identified any witnesses to establish that the Promotional Expenses are not ordinary and necessary in the context of TelexFree's business. The Service has offered no evidence establishing that a lesser amount of Promotional Expenses would have achieved the revenues generated by TelexFree.

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The Service's actions in disallowing the Promotional Expenses were arbitrary and excessive. Because the Service's actions were arbitrary and because it cannot meet its burden of proving that the claimed deductions are improper, the Promotional Expenses should be allowed in the amounts claimed on the returns.

The Service's position that the Promotional Expenses are not deductible because they do not satisfy the "all events" test is contrary to the undisputed facts and established law, and without foundation. The amount of a deduction that may be taken in a tax year is based upon the method of accounting used by the taxpayer to compute taxable income. 26 U.S.C. §461(a). While the "ordinary and necessary" criteria determine *whether* an expense is deductible, the timing of *when* the expense may be taken is governed by the "all events" test. The "all events" test, as codified in 26 U.S.C. §461, requires that in order for an expense to be deductible in a given tax year, all events must have occurred to determine the existence of the liability, the amount of such liability can be determined with reasonable accuracy, and economic performance has occurred. 26 U.S.C. §461(h)(1), (4).

TelexFree became obligated for the credits when they were issued to Participants for their promotional activities because such credits were immediately redeemable for cash or the purchase of membership plans. SUF, at ¶ 10. The amount of the credits is accurately reflected in the TelexFree books and records. SUF, at¶ 8-9. TelexFree deducted these expenses on its tax returns in the year that the credits were issued. SUF, at ¶ 56. The Service's contention that the Promotional Expenses do not satisfy the all events test because such expenses would never be paid is belied by the history of TelexFree's operations. TelexFree consistently redeemed credits during its operation, as set forth in more detail *infra*. In fact, in each year, Participants redeemed all or substantially all of the credits that were issued. SUF, at ¶ 12. The Service's

disallowance of the Promotional Expenses has no support in the record and is contrary to established law that payment of an accrued expense need not be certain in order to be deductible. *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986). In the *Hughes* case, the taxpayer filed its return using the accrual method of accounting and deducted payoffs on its progressive slot machines that had yet to be paid. In concluding that the expense was deductible, the *Hughes* court observed:

> There is always a possibility, of course, that a casino may go out of business, or surrender or lose its license, or go into bankruptcy, with the result that the amounts shown on the jackpot indicators would never be won by playing patrons. But this potential nonpayment of an incurred liability exists for every business that uses an accrual method, and it does not prevent accrual.
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> *Id*. at 606.

Deductions for expenses are appropriate when it cannot be categorically said that at the time the deductions were incurred the liability would not be paid, even if the likelihood of payment was doubtful. *Cohen v. Commissioner*, 21 T.C. 855, 856 (1954). Otherwise, only solvent entities would be permitted to take expense deductions. *In re Dow Corning*, 270 B.R. 393 (E.D. Mich. 2002)(taxpayer's solvency is not an precondition to expense accrual).

The Service's argument that allowance of the Promotional Expenses should at best be limited to amounts paid in cash is contrary to the well-established principles of taxation for an accrual-based taxpayer. 26 U.S.C. §448. For tax purposes, TelexFree LLC is treated as a subchapter C corporation. SUF, at ¶ 17. With three exceptions not applicable here, corporations are required to calculate taxable income under the accrual method.[7] *Id.* The accrual basis of accounting requires that income be recognized when the right to receive a set amount of income

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[7] The Trustee has reported all TelexFree activity on one tax return, as the three debtors operated as a single entity with a single set of books and records.

has been earned, regardless of when it is paid. *Houchin v. Commissioner*, 2006 Tax Ct. Memo LEXIS 121 (T.C. 2006). Similarly, the accrual method of accounting requires expenses to be claimed when they are incurred, not necessarily when they are paid. *Mass. Mut. Life Ins. Co. v. United States*, 103 Fed. Cl. 111 (Cl. Ct. 2012).

Consistent with the accrual basis of accounting, TelexFree recognized income when it sold a membership plan, and it recognized Promotional Expenses when the credits were issued to Participants and the expense was incurred. SUF, at ¶20. In any case, the Service is precluded from changing TelexFree's method of tax accounting because it did not any provide written notice to the Trustee of a change in TelexFree's method of tax accounting. SUF, at ¶24; Rev. Proc. 2002-18, §7.01.

D. The deduction for the debt due from Ympactus was appropriate, and the Service's disallowance of the deduction was arbitrary and without any rational basis.

The Service's disallowance of the Ympactus bad debt deduction was arbitrary, without foundation, and contrary to well-established law because TelexFree was engaged in a trade or business, it reported the Ympactus income on its tax returns, and the account receivable due from Ympactus to TelexFree became uncollectible when the Brazilian governments seized the assets of Ympactus. Accordingly, the Ympactus bad debt is appropriately deductible in 2013.

Section 166 of the IRC permits a deduction for business debts that become uncollectible in any given tax year. 26 U.S.C. §166(a). A business debt, in turn, is a debt created in connection with a trade or business and/or a debt incurred in the taxpayer's trade or business that subsequently becomes a loss from being uncollectible. 26 U.S.C. §166(d)(2). A deduction may be taken by a taxapayer engaged in a trade or business for the write off of a debt as uncollectible if the income pertaining to that debt was included in the taxpayer's taxable income

for the year in which the bad debt deduction is claimed, or for a prior year. Treas. Reg. §1.166-1(c).

Pursuant to 26 U.S.C. §166, a taxpayer may take a deduction for a debt if it becomes uncollectible in a taxable year. The determination of whether a debt is uncollectible depends upon the pertinent evidence, including the financial condition of the account debtor, establishing that the debt owed is not recoverable. Treas. Reg. §1.166-2; *Portland Manufacturing v. Commissioner*, 56 T.C. 58 (1978). The cessation of an account debtor's business is sufficient to substantiate that the debt is uncollectible. *Delk v. Commissioner*, 113 F.3d 984, 986 (9th Cir. 1997).

TelexFree reported as income from Ympactus $11,869,444 on its 2012 tax return and reported an additional $174,183,645 as income from Ympacus on its 2013 tax return. SUF, at ¶79-80. In that same year, TelexFree took a bad debt deduction for these amounts because Ympactus was shut down and its assets were seized by the Brazilian government. SUF, at ¶ 82. In accordance with Treas. Reg. §1.166-1(c), the Ympactus bad debt is a deductible expense.

E. TelexFree suffered a casualty loss when its assets were seized and is entitled to a deduction on account thereof.

TelexFree sustained a casualty loss when, shortly after the Chapter 11 filings, the federal government seized approximately $148,000,000 in cash and property of TelexFree. SUF, at ¶ 84.

A taxpayer may take a deduction for a loss sustained during the taxable year which is not compensated for by insurance or otherwise 26 U.S.C. §165(a). In contrast, criminal fines or

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penalties paid by a taxpayer to a government are not deductible 26 C.F.R. §1.162-21(a)(1), (b)(1)(i).[8]

The United States indicted TelexFree's principals James Merrill and Carlos Wanzeler. *See Indictment and Superceding Indictment ("Indictment") in United States v. James Matthew Merrill, et al.*, 4:14-cr-40028-TSH, in the United States District Court for the District of Massachusetts. SUF, at ¶85, 86. The Indictment did not name TelexFree as a defendant. *Id.* No criminal fines or penalties were sought or assessed against TelexFree. SUF, at ¶88. After Mr. Merrill pled guilty to Counts One through Nine of the Indictment, the United States sought and obtained a preliminary order of forfeiture with respect to Merrill and any other third party asserting an interest in the seized property. *Id.*, at docket no. 347 (*Preliminary Order of Forfeiture*). The preliminary order of forfeiture provided potentially interested parties with a fixed amount of time in which to assert an interest in the assets seized. *Id.*

The Trustee did not object to or challenge the preliminary order of forfeiture. SUF, at ¶90. This determination was made based upon the government's agreement to turn over the seized funds to the Trustee for distribution to Participants as restitution. *See id.,* at docket no. 332 (*Government Sentencing Memorandum*); docket no. 367 (*Restitution Order*); docket no. 398 (*Order to Apply Forfeited Funds to Restitution*).

TelexFree's seized assets have been delivered to the Trustee to be used to pay restitution to victims, and not as a punitive measure. SUF, at ¶ 94; *Restitution Order, Order to Apply Forfeited Funds to Restitution*. Because the seized funds were not on account of a criminal fine or penalty against TelexFree and because the funds are intended to be used as restitution and not

[8] Congress amended Section 162(f) of the IRC in 2017. This case is governed by the prior version of Section 162(f) as in effect in 2014. *See* P.L. 115-97 § 13306(a)(2)(amendments apply to amounts paid or incurred on or after enactment of the act).

as a penalty, the casualty loss is deductible. *Stephens v. Commissioner*, 905 F.2d 667 (2nd Cir. 1990)(deduction for restitution payment did not frustrate public policy).

Each of the cases cited by the Service in support of its position is distinguishable. In *Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016), the government imposed a forfeiture penalty upon the taxpayer for insider trading violations. The court judgment specifically provided that the amount of restitution was $0 and that restitution was not available. *Id*. at 1380. *Nacchio* distinguished itself from the *Stephens* decision, *infra,* where restitution was imposed upon the taxpayer at his sentencing hearing for white collar crime violations, and the restitution payments were later found to be deductible. Unlike *Nacchio*, TelexFree was not subject to a criminal fine or penalty. Like *Stephens*, restitution was agreed to as a remedy at the sentencing hearing for Mr. Merrill. To the extent the Court need consider public policy implications associated with the deduction for the seized funds, there is no frustration of public policy where the funds to be used as compensation for victims are part of a concerted plan of the Court appointed Trustee and the various governmental agencies to provide restitution to victims. *See Stephens, infra.*

In both *King v. United States*, 152 F.3d 1200 (9th Cir. 1998) and *Wood v. United States*, 863 F.2d 417 (5th Cir. 1989) cited by the Service, the taxpayer was engaged in the sale of illegal narcotics. The federal government seized the fruits of this activity as forfeited funds. In both instances, the taxpayer, who was subject to a penalty in the nature of forfeiture, was denied a deduction for the loss.[9] Similar results occurred in *Hackworth v. Commissioner*, 155 Fed.

[9] *Thrower v. Commissioner*, 2003 Tax Ct. Memo LEXIS 138 (U.S.T.C. 2003), cited by the United States, held that the Service failed to prove by competent evidence that the taxpayer had earnings from illegal activities. In dicta, the court noted that losses from asset forfeiture of a drug trafficker are not deductible. This point of law is not relevant to TelexFree for the reasons cited *infra.*

Appx. 627 (4th Cir. 2005)(taxpayer engaged in illegal gambling and forfeiture loss could not be deducted); and *Fuller v. Commissioner*, 213 F.2d 102 (10th Cir. 1954)(taxpayer selling liquor in violation of state law could not take a deduction). These cases are distinguishable from TelexFree in that the taxpayer was the subject of the penalty and there was no suggestion that the funds were paid as restitution to victims.

Other cases cited by the Service are inapplicable. *United States v. Blackman,* 746 F.3d 137 (4th Cir. 2014) is irrelevant to disposition of the present case. In *Blackburn,* the court determined that in a circumstance where the defendant was guilty of armed robbery, forfeiture was not a discretionary element of sentencing. The case did not address the tax consequences of the forfeiture. In *Tank Truck Rentals v. Commissioner*, 356 U.S. 30 (Sup. Ct. 1958), the taxpayer was denied a deduction for fines imposed upon it and its drivers for violating state maximum weight laws in transporting cargo. The case is inapplicable in this instance because that taxpayer sought a deduction under Section 162 of the IRC as an ordinary and necessary business expense. The case did not address the applicability of a casualty loss under Section 165 of the IRC.

II. Conclusion

The Promotional Expenses constitute ordinary and necessary expenses of TelexFree's business. The Ympactus bad debt deduction is proper because TelexFree reported the income from Ympactus on its tax returns, which later became uncollectible when the Brazilian government seized the assets of Ympactus. The casualty loss deduction is proper because TelexFree was not subject to a criminal fine or penalty and the seized funds will be used to pay restitution to Participants.

III. Summary Judgment Pursuant to FRCP 56(f)

FRCP 56(f) provides in relevant part that:

(f) After giving notice and a reasonable time to respond, the court may –

(1) Grant summary judgment for the nonmovant;
(2) Grant the motion on grounds not raised by a party; or
(3) Consider summary judgment on its own after identifying for the parties material facts that may not be genuinely in dispute.

The Service has failed to meet its burden of proof that the deductions claimed by the Trustee should be disallowed. The Trustee has established that based on the undisputed facts he is entitled to judgment as a matter of law that the deductions claimed for Promotional Expenses, the Ympactus bad debt loss and the casualty loss are property deductible. Accordingly, pursuant to FRCP 56(f), the Court should deny the Service's motion for summary judgment and enter judgment for the Trustee on Counts I, II, and III of the Complaint.

Respectfully submitted,
STEPHEN B. DARR, CHAPTER 11 TRUSTEE,
By his counsel:

Dated: November 4, 2019

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