Docket #0014 Date Filed: 10/19/2018

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

MEMORANDUM OF LAW IN SUPPORT OF MOTION BY CHAPTER 11 TRUSTEE FOR PARTIAL SUMMARY JUDGMENT

The Chapter 11 Trustee's motion for partial summary judgment seeks a determination that the Internal Revenue Service has no administrative claims in these cases and that, if and to the extent any portion of the Service's claims are allowed, such claims should be treated as prepetition unsecured claims. The facts material to the motion are well-established and not controverted.[1]

[1] The facts relevant to this dispute are set forth more fully in the Statement by Chapter 11 Trustee of Undisputed Material Facts in Support of Motion for Partial Summary Judgment, filed contemporaneously herewith.

I. Factual Statement

A. The TelexFree Business

On April 13, 2014 (the "Petition Date"), each of TelexFree, Inc., TelexFree, LLC, and TelexFree Financial, Inc. (collectively, "TelexFree" or the "Debtors") filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code ("Bankruptcy Code") with the United States Bankruptcy Court for the District of Nevada. The cases were later transferred to the Court pursuant to a motion to change venue filed by the Securities and Exchange Commission ("SEC"). The Debtors remained in possession of their assets pursuant to Sections 1107 and 1108 of the Bankruptcy Code until Stephen Darr (the "Chapter 11 Trustee") was appointed on June 6, 2014.

On April 15, 2014, the SEC commenced an action against the Debtors and others in the United States District Court for the District of Massachusetts asserting that the Debtors were engaged in an illegal Ponzi/pyramid scheme and the fraudulent and unregistered offering of securities. Substantially contemporaneously with the commencement of the SEC action, Homeland Securities Investigation ("HSI") seized the Debtors' assets, books, and records. The Debtors' operations were suspended as a result of the actions by the HSI, and TelexFree did not generate any revenue after the Petition Date.

Upon his appointment, the Chapter 11 Trustee retrieved and reconstructed the TelexFree written and electronic records that were seized by the federal authorities through a painstaking data analysis and recovery process. The Chapter 11 Trustee used these records, along with other investigative tools, to determine the mechanics of the TelexFree Ponzi scheme and how transactions were processed and recorded.

The Debtors purported to be in the business of selling a voice over internet service, or "VoIP" to conduct international phone calls. The Debtors ostensibly used a multi-level marketing plan to sell the VoIP packages. TelexFree sold membership plans to its members, or "Participants", which provided Participants with the opportunity to recruit other Participants and to sell VoIP packages, although the phone plans were rarely sold and those that were sold were hardly ever used. The product that TelexFree sold was, in reality, the membership plans and the right to earn credits by advertising TelexFree and recruiting other Participants. TelexFree promised its members substantial returns for placing daily internet advertisements. The ability to earn credits enticed individuals into the program, generated growth and widespread interest among Participants and perpetuated the business. The issuance of the credits, whether for advertisement or recruiting new Participants, was essential to increase TelexFree's customer base and encouraged current Participants to purchase additional plans and recruit additional Participants.

The use of the credits for advertising was instrumental to the implementation and growth of the business, as the credits served as a form of currency amongst the Participants and TelexFree. The credits issued to Participants could be redeemed for cash or could be used to purchase additional membership plans or VoIP packages. Invoices for the purchase of a membership plan or VoIP package could be satisfied in one of two ways. Participants could pay the invoice in cash directly to the Debtors, or Participants could pay a recruiting Participant for the purchase of a membership plan, who then redeemed accumulated credits to satisfy the TelexFree invoice (referred to as a "Triangular Transaction"). Accordingly, the issuance of credits to Participants represented an essential expense necessary to growing the business. In the TelexFree Ponzi scheme, as with any Ponzi scheme, it was necessary to allow individuals to

monetize their credits either by redeeming the credits for cash or through their use in Triangular Transactions, thereby providing credence to the business.

Ultimately, the TelexFree program involved upwards of 1,000,000 Participants, from both the United States and more than forty (40) other countries, who collectively lost in excess of $1,700,000,000.

B. Status of Tax Returns and Related Claims

As of the Petition Date, TelexFree had filed a federal income tax return for calendar year 2012 but had not filed a return for calendar year 2013. On March 17, 2014, the original due date for filing its 2013 federal income tax return, TelexFree attempted to pay its 2013 estimated tax electronically. That payment was rejected. On March 31, 2014, TelexFree successfully submitted a payment to the Service in the amount of $15,792,982 for any potential income tax liability for calendar year 2013. After his appointment, the Chapter 11 Trustee retained KPMG, LLC as tax accountants and advisors to prepare and file necessary original and amended tax returns. With the assistance of KPMG, the Chapter 11 Trustee filed original tax returns for TelexFree LLC for tax years 2013 and 2014 and later filed amended returns for 2013 and 2014, as well as filing first and second amended returns for tax year 2012. The returns were filed in accordance with the well-established principle that expenses incurred in connection with the operation of an illegal business operation are tax deductible.

Specifically, on September 12, 2016, the Chapter 11 Trustee filed a tax return for TelexFree LLC for tax year 2013 (the "Original 2013 Return") which reflected a taxable loss of $2,101,985,935 and a refund due of $15,858,111.[2] Given TelexFree's growing insolvency as the

[2] In error, the Original 2013 Return reported 2013 estimated tax payments of $15,858,111, which formed the basis for the refund requested. As noted above, payments on the 2013 account totaled $15,792,982, not $15,858,111. Accordingly, the Original 2013 Return, which reported no tax

Ponzi scheme expanded, it is not surprising that the Original 2013 Return reported substantial losses. By September 2016, the Service had been alerted to the filing of the petition. In fact, during this time frame, both the Chapter 11 Trustee and KPMG actively coordinated with the Service's Insolvency Advisor and Large Business & International Division Revenue Agent that the Service had assigned to TelexFree's bankruptcy cases. By September 2016, the Service had placed litigation and active examination controls on TelexFree's accounts. Furthermore, the Chapter 11 Trustee requested prompt refunds and prompt determinations from the Service under Sections 505(a) and 505(b) of the Bankruptcy Code.

Nevertheless, on December 26, 2016, the Service processed TelexFree's Original 2013 Return, making an assessment on its books and records that TelexFree owed zero tax for the 2013 tax year. On December 27, 2016, the Service issued a refund to TelexFree LLC relating to the 2013 tax year in the amount of $15,532,440 (the "2013 Refund"). The 2013 Refund was comprised of three components: the estimated taxes paid of $15,792,982, plus accrued interest of $55,318, less a $315,860 bad check penalty.[3] Despite the Service's initial acceptance of the Original 2013 Return, the zero-dollar assessment, and the Service's issuance of the 2013 Refund, the examination division of the Service later disallowed substantially all expenses claimed by the Chapter 11 Trustee and issued a notice of deficiency for tax year 2013. In other words, the Service now claims that it made a mistake in processing the Original 2013 Return and issuing the 2013 Refund. The Service filed an administrative proof of claim in the amount of

liability, in effect, sought a refund of $15,792,982.

[3] The Chapter 11 Trustee filed a penalty abatement request for the bad check penalty, which has not yet been allowed by the Service.

$15,532,440.39 for tax year 2013, representing the amount refunded to the Chapter 11 Trustee [Claim No. 2987 filed with the Court].[4]

On June 27, 2017, the Chapter 11 Trustee filed an original tax return for the Estate of TelexFree LLC for calendar year 2014 reflecting revenue of $161,550,353, expenses of $2,450,176,063, and a taxable loss of $2,288,625,710. As with the 2013 return, the Service disallowed substantially all of the expenses claimed by the Chapter 11 Trustee on the 2014 return. On November 30, 2017, the Service filed an amended administrative proof of claim [Claim No. 2987-2 filed with the Court] against the TelexFree LLC Estate asserting an administrative claim in the aggregate amount of $69,460,404 [as amended, the "Administrative Claim"]. The Administrative Claim was amended to add a claim in the amount of $53,927,964 for income tax allegedly incurred for calendar year 2014 by the TelexFree LLC Estate. The Service effectively took the position, for both 2013 and 2014, that TelexFree was generating an enormous profit at the same time it was incurring obligations far beyond its ability to pay in the course of its business.

On or about March 7, 2018, the Chapter 11 Trustee filed amended tax returns for 2013 and 2014 (the "Amended Tax Returns"). The amended tax return for 2013 (the "Amended 2013 Return") reflected a taxable loss of $3,143,851. The amended tax return for 2014 (the "Amended 2014 Return") reflected a taxable loss of $535,594,148. The Chapter 11 Trustee

[4]The Service also filed a prepetition proof of claim against the Estate of TelexFree LLC in the amount of $356,898,861.36 for tax year 2013, consisting of a prepetition priority unsecured claim in the amount of $285,710,295 and a prepetition nonpriority unsecured claim in the amount of $71,188,567 [Claim No. 3456 filed through the electronic claims portal established by the Chapter 11 Trustee, hereafter the "Prepetition Claim"].

prepared and filed these returns as additional information became available. The Service has taken no action respecting the Amended Tax Returns.

On August 14, 2018, the Service informed the Chapter 11 Trustee that pursuant to Tax Division Directive No. 137, the Service agreed to subordinate the Prepetition Claim and $52,593,821 of the Administrative Claim to the payment of allowed administrative claims and allowed claims of Participants. Tax Division Directive No. 137 recognizes the appropriateness of subordinating tax claims to the claims of investors who are victims of an illegal business. The Service has not agreed to subordinate so much of the Administrative Claim as was computed based upon income tax liability for tax year 2013 relating to the 2013 Refund (the "2013 Claim") and $1,334,143 of alleged calendar year 2014 income tax liability (the "2014 Claim").

The Chapter 11 Trustee commenced this adversary proceeding seeking a determination that no tax liability is owing to the Service for calendar years 2012, 2013, and 2014, and that the Chapter 11 Trustee is entitled to retain the 2013 Refund and to receive a refund of taxes paid for 2012. The Complaint has five counts; the Chapter 11 Trustee seeks summary judgment on Counts IV and V. In Count IV, the Chapter 11 Trustee requests declaratory judgment that to the extent TelexFree LLC has any income tax liability for calendar year 2013, any claims arising therefrom are entitled only to status as a prepetition unsecured claim and not as an administrative claim. Count V requests the same determination as to claim priority with respect to any income tax liability for calendar year 2014, as all business activity occurred prior to the Petition Date.

II. STANDARDS FOR SUMMARY JUDGMENT

Summary judgment is appropriate when the record reveals "no genuine dispute as to any material fact and the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a); Fed. R. Bank. P. 7056. "The role of summary judgment is to pierce the boilerplate of the

pleadings and to provide a means for prompt disposition of cases where no trial-worthy issue exists." *Quinn v. City of Boston*, 325 F.3d 18, 28 (1st Cir. 2003) (citing *Suarez v. Pueblo Int'l, Inc.*, 229 F.3d 49, 53 (1st Cir. 2000)). "A 'genuine' issue is one that could be resolved in favor of either party, and a 'material fact' is one that has a potential of affecting the outcome of the case." *Calero-Cerezo v. U.S. Dept. of Justice*, 355 F.3d 6, 19 (1st Cir. 2004) (citing *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248-250 (1986)).

"To be considered 'genuine' for Rule 56 purposes a material issue must be established by 'sufficient evidence supporting the claimed factual dispute…to require a jury or judge to resolve the parties' differing versions of the truth at trial.'" *Hahn v. Sargent*, 523 F.2d 461, 464 (1st Cir. 1975) (quoting *First National Bank of Arizona v. Cities Service Co., Inc.*, 391 U.S. 253, 289 (1968)). "Once the movant has served a properly supported motion asserting entitlement to summary judgment, the burden is on the non-moving party to present evidence showing the existence of a trial worthy issue." *Gulf Coast Bank & Trust Co. v. Reder*, 355 F.3d 35, 39 (1st Cir. 2004) (citing *Anderson*, 477 U.S. at 248); *Garside v. Osco Drug, Inc.*, 895 F.2d 46, 48 (1st Cir. 1990). To meet that burden, the non-moving party may not rely on "bare allegations" but must come forward with substantive evidence to rebut the evidence that has been offered by the moving party. *Gulf Coast*, 355 F.3d at 39 (citing *Rogan v. City of Boston*, 267 F.3d. 24, 29 (1st Cir. 2001)).

The Chapter 11 Trustee believes that the facts are uncontroverted for purposes of adjudicating Counts IV and V of the Complaint and that he is entitled to a judgment as a matter of law.

III. ARGUMENT

Introduction

With respect to both Counts IV and V, the issue of law is whether, to the extent the Service has any claim at all, such claim should be accorded administrative priority status or prepetition unsecured status.

A core principle of the Bankruptcy Code is that the limited assets of a debtor should be ratably distributed among all of the holders of unsecured claims. *In re Hemingway Transp.*, 954 F.2d 1 (1st Cir. 1992). Exceptions to this core principle are strongly disfavored and narrowly construed. *In re Morad*, 328 B.R. 264 (1st Cir. BAP 2005); *In re O.P.M. Leasing Services, Inc.*, 68 B.R. 979, 985 (Bankr. S.D.N.Y. 1987); *In re Bayou Group, LLC*, 431 B.R. 549 (Bankr. S.D.N.Y. 2010). The Bankruptcy Code imposes a heavy burden on the entity seeking entitlement to administrative status to establish the existence of the exceptional circumstances to warrant such an entitlement. *Hemingway Transp.*, 954 F.2d at 5.

In the present case, the Service asserts that TelexFree owes a tax liability for 2013 and because the Service erroneously issued a refund with respect to that year, the 2013 tax liability should be accorded administrative priority status.[5] The Service's position is directly contrary to the express and unambiguous language of Sections 507(a)(8) and 507(c) of the Bankruptcy Code. The Service further asserts that any income tax liability for 2014 should be accorded administrative priority status because TelexFree filed for bankruptcy in 2014. All of TelexFree's revenue in 2014, however, was generated prior to the Petition Date and therefore any income tax liability for 2014 cannot satisfy the requirements for administrative priority status set forth in

[5] The Chapter 11 Trustee disputes all amounts claimed by the Service and asserts that no amounts are owing. The amount of the Service's claim, if any, is not relevant to the Chapter 11 Trustee's summary judgment motion.

Section 503(b) of the Bankruptcy Code. Further, the allowance of such administrative claims impairs the Chapter 11 Trustee's ability to administer the TelexFree Estates and the recovery to more than 100,000 victims who have filed claims in these cases.

Accordingly, the Service's Administrative Claim must be disallowed.

A. To the extent that the Service has an allowed claim for the 2013 Claim, such claim should be treated as a prepetition priority unsecured claim.

I. The Service cannot satisfy the standards for allowance of an administrative claim with respect to the 2013 Claim.

The 2013 Claim cannot satisfy the requirements for entitlement to administrative priority status set forth in Section 503(b) of the Bankruptcy Code. Section 503(b)(1)(B)(i) of the Bankruptcy Code provides as follows:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including-
>
> (1)(B) any tax-
>
> (i) *incurred by the estate*, whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both, except a tax of a kind specified in section 507(a)(8) of this title. (emphasis added)

The 2013 Claim was not "incurred by the estate" as the entire tax year occurred prepetition. *See, e.g., In re Johnson*, 190 B.R. 724, 727 (Bankr. D. Mass. 1995)(federal income taxes are incurred at the time that the taxes accrue). Rather, the 2013 Claim would constitute, at most, a prepetition priority unsecured claim pursuant to the provisions of 11 U.S.C. §507(a)(8)(A)(i) which provides a prepetition eighth priority claim for:

> (A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition –
>
> (i) For which a return, if required, is last due, including extension, after three years before the date of the filing of the petition.

Any tax liability of TelexFree arising from tax year 2013 was not 'incurred' by the Estate and any such claim is of a kind specified in Section 507(a)(8) of the Bankruptcy Code. Therefore, to the extent that any claim can be established in further proceedings before the Court, the 2013 Claim is not entitled to administrative priority status. Such claim should be entitled only to prepetition unsecured claim status.

II. The plain language of Section 507(c) mandates that the 2013 Claim be treated as a prepetition, priority claim irrespective of the timing of the 2013 Refund.

The Service seeks to transform its garden variety prepetition tax claim for tax year 2013 into an administrative claim because it issued a refund to the Chapter 11 Trustee for that year, which it now alleges to have been in error. Congress specifically addressed this scenario in Section 507(c) of the Bankruptcy Code. Section 507(c) provides that:

> For the purpose of subsection (a) of this section, a claim of a governmental unit **arising from an erroneous refund** or credit of a tax has the same priority as a claim for the tax to which such refund or credit relates. (emphasis added)

The plain and unambiguous language of Section 507(c) requires that the 2013 Claim be accorded prepetition priority unsecured status, as the claim pertains to tax year 2013, which was a prepetition tax year.

It is a fundamental principle of statutory interpretation that the court should begin with the language of Section 507(c) itself. *In re Town & Country Corp.*, 2000 Bankr. LEXIS 1755, at *17 (1st Cir. BAP 2000). Where the language of the statute is clear and unambiguous, which is the case with respect to Section 507(c), the sole function of the court should be to enforce the statute in accordance with its terms. *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (U.S. 1989); *Caminetti v. United States*, 242 U.S. 470, 485 (1917); *Lawrence v. City of Phila, Pa.*, 527 F.3d 299, 316-17 (3rd Cir. 2008).

The plain meaning rule is derived from the fundamental principle that the courts are to enforce the laws as enacted by Congress. The intent of the rule is to restrain the court from making policy decisions where the intent of Congress is expressed in the clear and plain language of the statute. *Pub. Citizens v. U.S. Dept. of Justice*, 491 U.S. 440, 470-71 (1989). *See also Lamie v. United States Trustee*, 540 U.S. 526, 536 (2004). The plain meaning rule requires the court to "read the statute in its ordinary and natural sense." If the plain meaning is conclusive, the court should end its inquiry and apply the statute as written. Only in the rare instance where the literal application of the statute produces a result demonstrably at odds with the intention of the drafters should the court deviate from the application of this rule. *Harvard Secured Creditors Liquidation Trust v. I.R.S. (In re Harvard Indus., Inc.)*, 568 F.3d 444, 451 (3d Cir. 2009); and *Griffin v. Oceanic Contractors Inc.*, 458 U.S. 564, 571 (1982).

In the present case, the plain and express language of Section 507(c) is dispositive of the issue. The claim for the 2013 Refund (Claim No. 2987) is not entitled to administrative claim status, but has the same priority as a claim for the tax to which the refund relates, which is the prepetition claim for the 2013 tax year.

Breaking down the constituent parts of Section 507(c), the preamble notes that the statute is "for the purpose of subsection (a)" of Section 507 of the Bankruptcy Code. Section 507(a) governs the allowance of *both* administrative claims [11 U.S.C. §507(a)(1)-(2)] and prepetition priority unsecured claims [11 U.S.C. §507(a)(4)-(10)].[6] The statute is therefore directly relevant to the Service's assertion of an administrative claim relating to the 2013 Claim. The claim asserted by the Service "arises from" the issuance of the refund, as the amount of the claim is equal to the amount of the 2013 Refund paid to the Chapter 11 Trustee. In this circumstance,

[6] Section 507(a)(3) pertains to gap period claims in an involuntary case.

Section 507(c) requires that the Service's claim be granted the same priority as a claim for the year 2013 tax, which is the "tax to which the refund or credit relates". As set forth above, and which should be without controversy, claims of the Service arising for unpaid taxes for year 2013 should be accorded, at most, prepetition priority unsecured status as falling squarely within the provisions of Section 507(a)(8). The Service's attempt to create a separate claim for a return of the refund, as distinguished from a claim for payment of the underlying tax for year 2013, is completely at odds with the clear language of Section 507(c).

In *In re Motor Freight Express*, 1988 Bankr. LEXIS 2608 (Bankr. E.D. Pa. 1988), the court was presented with facts substantially similar to those presented here. In that case, the Service asserted an administrative claim against the Chapter 11 debtor-in-possession for recovery of refunds made during the administration of the case asserted to be made in error, even though the underlying tax related to prepetition tax periods. The debtor disputed the priority status of the Service's claim. The court found the clear and express provisions of Section 507(c) to be determinative of the issue, holding "irrespective of when the error is discovered *or the 'erroneous payment' is made*," the tax claim for return of the refund has the same priority as a claim for the tax to which the refund relates. *Id.* at *6, 7 (emphasis added). Since the refund related to a tax claim for a prepetition year, the Service's claim was treated as a prepetition, priority unsecured claim. *Id.* at *7, 8. This Court should reach the same conclusion as to the Service's 2013 Claim.

The courts have reached similar conclusions in *In re Scrap Disposal Inc.*, 38 B.R. 765 (9th Cir. BAP 1984) and *In re Frontone*, 383 F.3d. 656 (7th Cir. 2004). In *Scrap Disposal*, the court relied upon Section 507(c) to find a local taxing authority that issued a supplemental property tax bill postpetition based on an error in the original computation was not entitled to an

administrative claim. The *Scrap Disposal* court concluded that an application of the plain language of Section 507(c) required a finding that that postpetition assessment related back to the prepetition tax year. *Id.* at 767. Similarly, in *Frontone*, the Court looked to the plain language of Section 507(c) to determine that a mistakenly issued refund constituted a tax which related to the tax year it was incurred. *Id.* at 660.

The Service may direct the court to *In re Campbell*, 1990 Bankr. LEXIS 2922 (Bankr. D. Col. 1990) as supporting the argument that the 2013 Refund should be treated as an administrative claim. While the reasoning of the *Campbell* decision is confusing, ultimately it is distinguishable from the present case because the *Campbell* court found that the postpetition payment by the Service was not an erroneous refund; therefore, Section 507(c) was not applicable to a determination of the priority of the Service's claim. In the present case, the Service acknowledges that the payment was an erroneous refund relating to the 2013 tax year.

Based upon the plain meaning of Section 507(c), the Chapter 11 Trustee requests that the Court enter summary judgment on Count IV, finding that the 2013 Claim be allowed as a prepetition, priority unsecured claim, to the extent that any claim can be established after further proceedings before the Court.

The Service asserted a counterclaim for return of the 2013 Refund. The counterclaim is in reality just a restatement of the Service's position that the 2013 Claim should be accorded administrative priority status. If the Court grants summary judgment to the Chapter 11 Trustee on Count IV, finding that the 2013 Claim is entitled to, at most, status as a prepetition priority unsecured claim, then in such case the Chapter 11 Trustee requests the Court dismiss the counterclaim as being moot.

B. To the extent the Service has any claim for income tax liability relating to calendar year 2014, such claim should be treated as a prepetition unsecured claim.

Because all of TelexFree's income for calendar year 2014 was generated prior to the Petition Date, any claim that the Service may have for income tax liability relating to calendar year 2014 that has not been subordinated should be treated as a prepetition unsecured claim.

The requirements for establishing a right to an administrative tax claim pursuant to Section 503(b)(1)(B)(i) of the Bankruptcy Code are set forth in Section A of this Memorandum and are incorporated herein. Most importantly, in order to establish the right to an administrative tax claim, the Service must demonstrate that any tax liability on account of tax year 2014 was "incurred by the estate". The term "incurred" is not defined in the Bankruptcy Code. *In re Pacific-Atlantic Trading Co.*, 64 F.3d 1292 (9th Cir. 1995). Although the term "incurred" is not defined, the "clear weight of authority" holds that for purposes of Section 503(b)(1)(B), federal income taxes are incurred at the time that the taxes accrue, rather than when the taxes become due. *In re Johnson*, 190 B.R. 724, 727 (Bankr. D. Mass. 1995). This conclusion is supported by the legislative history of Section 503(b), which states that administrative expenses include taxes on income "*earned by the estate during the case*." See S. Rep. No. 989, 95th Cong., 2d Sess. 66 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5852 (emphasis added).[7] Furthermore, the conclusion that federal income taxes are incurred when they accrue is compatible with the broad construction given the definition of "claims against the estate" as well as the narrow construction given the definition of "administrative expenses." *Johnson, infra. See also In re Dayhuff*, 185 B.R. 971, f/n 1 (Bankr. N.D. Ga. 1995)(most courts have concluded that the classification of tax-related claims is governed by the date of accrual, rather than the date of assessment); *In re*

[7] *See also 3 Collier on Bankruptcy*, para. 503.04[1](b), at 503-22 and 23 (15th ed.), which provides: To the extent a debtor's prepetition liability became a tax claim after the petition, it would not for that reason be given administrative expense status under section 503(b)(1)(B).

Wheeling-Pittsburgh Steel Corp., 103 B.R. 672, 693 (W.D. Pa. 1989)("It is a well-settled rule that the time period when the tax obligation accrues is the crucial factor in determining priority of the tax, rather than the date a tax return is due.").

Any tax incurred for calendar year 2014 should be treated as a prepetition claim because the TelexFree business was shut down at the time of the bankruptcy filing and no revenue was recognized after that time. For example, in *In re O.P.M. Leasing Services, Inc.*, 68 B.R. 979, 985 (Bankr. S.D.N.Y. 1987), the fiscal tax year for the debtor ran from December 1, 1980 through November 30, 1981. The debtor's bankruptcy petition was filed on March 11, 1981, thereby straddling the applicable tax year (hereinafter referred to generally as a "straddle year"). A dispute arose as to whether income taxes owed to the State of Indiana and accruing on amounts earned by the debtor between December 1, 1980 and March 11, 1981 (the prepetition portion of the straddle year) were entitled to administrative expense status. The *O.P.M.* court determined they were not so entitled. The *O.P.M.* court found that the liabilities of the estate do not "penetrate the barrier" of the petition date for purposes of imposing a post-petition, administrative expense claim on income earned pre-petition. *Id.* at 983. The court buttressed its holding by looking to the legislative history that administrative expenses should only include taxes on income "earned by the estate during the case". *Id.* at 985, *citing S. Rep. No. 989, 95th Cong., 2nd Sess. 66 (1978), infra. See also In re Hillsborough Holdings Corp.*, 156 B.R. 318 (Bankr. M.D. Fla. 1993) and *In re Interco, Inc.*, 143 B.R. 707 (Bankr. E.D. Mo. 1992)(tax liability arising during the prepetition portion of a straddle year was not "incurred by the estate"); *In re Goody's LLC*, 508 B.R. 891, 899-900 (Bankr. D. Del. 2014)(employer tax claim constituted a prepetition claim because the wages that gave rise to the employer tax claim were earned

prepetition – the wages and associated taxes were not actual and necessary costs associated with the preservation of the bankruptcy estates).

Although not decided in the context of tax claims, in *In re Boston Regional Medical Center*, 291 F.3d 111 (1st Cir. 2002), the First Circuit Court of Appeals' reasoning provides further support for the Trustee's position. In *Boston Regional*, the nonprofit debtor reimbursed the state unemployment compensation fund for benefits paid to terminated employees, in lieu of making regular contributions to the fund. The terminated employees performed their services prepetition but were paid by the fund after the petition date, and a dispute arose as to whether the fund's reimbursement claim was entitled to administrative status. The circuit court held that the debtor's obligation to reimburse the governmental agency would be entitled to administrative priority status only to the extent the compensation was paid on the basis of work performed by employees after the petition date. The circuit court ruled, consistent with its earlier holding in *In re Mammoth Mart*, "for a claim in its entirety to be entitled to first priority, the debt must arise from a transaction with the debtor-in-possession." *Boston Regional*, 291 F.3d at 124, *citing In re Mammoth Mart, Inc.*, 536 F.2d 950, 954 (1st Cir. 1976).

The cases holding that income tax liability arising during the prepetition portion of a straddle year may be treated as a prepetition claim generally found that such tax liability: (i) was not incurred by the estate; and (ii) qualified for treatment as a prepetition, priority unsecured claim under [then] Section 507(a)(7)(iii) of the Bankruptcy Code as a tax "not assessed before, but assessable under applicable law or by agreement after, the commencement of the case." Section 507(a)(7) was renumbered [as 507(a)(8)] in 1994 and amended in 2005 such that the

prepetition portion of the straddle year may no longer qualify for prepetition, priority unsecured treatment pursuant to Section 507(a)(8)(iii).[8]

Although the income tax liability attributable to the prepetition portion of a straddle year may no longer qualify for prepetition, priority unsecured treatment under Section 507(a)(8)(iii), the Service must still demonstrate that the 2014 tax was "incurred by the estate" in order to obtain an administrative priority claim. As set forth above, numerous courts have concluded that taxes incurred during the prepetition portion of a straddle year are not 'incurred by the estate.' Some courts have concluded, conversely, that income tax liability is not incurred until the last day of the tax year. *See, e.g., In re Earl Gaudio & Son, Inc.*, 2017 Bankr. LEXIS 207 (Bankr. C.D. Ill. 2017)(relating to state income tax liability); *In re FR&S Corp.*, 2011 Bankr. LEXIS 1307 (Bankr. D.P.R. 2011)(income taxes due to Commonwealth of Puerto Rico). Cases finding

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[8] Prior to 2005, renumbered Section 507(a)(8) provided priority unsecured treatment for income tax claims as follows:

(8) Seventh, allowed unsecured claims of governmental units, only to the extent that such claims are for –

(A) a tax on or measured by income or gross receipts—

(i) for a taxable year ending *on or before the date of the filing of the petition* for which a return, if required is last due, including extensions, after three years before the date of the filing of the petition (emphasis added)…

(iii)…not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case.

Prior to 2005, the requirement that the taxable year end on or before the petition date did not apply to Section 507(a)(8)(A)(iii). Pursuant to the 2005 BAPCPA amendments, renumbered Section 507(a)(8) provides for priority unsecured treatment of tax claims as follows:

(8) Eighth, allowed unsecured claim of governmental units, only to the extent of that such claims are for—

(A) a tax on or measured by income or gross receipts for a taxable year *ending on or before the date of the filing of the petition* – (emphasis added)

(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition…

(iii)…not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case.

that a tax for the entire year accrues as of the last day of the year generally rely upon the fact that the tax liability cannot be established until the end of the tax year and all taxable activity has been accounted for. This reasoning is inapplicable to the instant case, as TelexFree ceased operating at the time of the bankruptcy filing and all of the revenues for the 2014 year were earned prepetition. Under the particular circumstances of this case, where the Debtors had been shut down prepetition, conducted no postpetition operations and generated no postpetition revenues, the Court should treat any income tax incurred for year 2014 as having been incurred by the prepetition debtors and not by the Estates. Accordingly, the Service is not entitled to an administrative claim for tax year 2014.

IV. CONCLUSION

For the reasons set forth above, the Court should grant summary judgment in favor of the Trustee as follows:

1. On Count IV holding that, to the extent that the Service is entitled to a claim in the amount of the 2013 Refund and relating to tax year 2013, that such claim be accorded prepetition priority unsecured status pursuant to Sections 507(c), 507(a)(8), and 503(b) of the Bankruptcy Code, and dismissing the Service's counterclaim for return of the 2013 Refund as moot;

2. On Count V holding that, to the extent that the Service is entitled to a claim on account of income tax liability for amounts earned in 2014 prior to the Petition Date, that such claim be accorded prepetition unsecured status pursuant to 11 U.S.C. §503(b).

Respectfully submitted,

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

Dated: October 19, 2018

/s/ Andrew G. Lizotte

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