Docket #0015 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

STATEMENT BY CHAPTER 11 TRUSTEE OF UNDISPUTED MATERIAL FACTS IN SUPPORT OF MOTION FOR PARTIAL SUMMARY JUDGMENT

1. On April 13, 2014 (the "Petition Date"), each of TelexFree, Inc., TelexFree, LLC, and TelexFree Financial, Inc. (collectively, the "Debtors" or "TelexFree") 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 Nevada Bankruptcy Court").[1]

[1] The Court may take judicial notice of all facts reflected on the Court docket.

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2. The Debtors initially operated as debtors-in-possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

3. On the Petition Date, the Debtors filed a motion for joint administration of the cases, with TelexFree, LLC designated as the lead case [docket entry 4]. By order dated April 24, 2014, the order for joint administration was approved [docket entry 77].

4. On April 15, 2014, the Securities and Exchange Commission ("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. *Affidavit of Stephen Darr in Support of Motion by Chapter 11 Trustee for Partial Summary Judgment ("Affidavit")*, at ¶7.

5. Substantially contemporaneously with the commencement of the SEC action, Homeland Securities Investigation ("HSI") seized the Debtors' assets, books, and records. *See Affidavit* at ¶8. 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. *Affidavit*, at ¶8.

6. On or about April 22, 2014, the Office of the United States Trustee filed a motion for the appointment of a Chapter 11 Trustee [docket entry 65].

7. On April 23, 2014, the SEC filed a motion to transfer venue of the cases to the United States Bankruptcy Court for the District of Massachusetts (the "Court") [docket entry 67]. By order dated May 6, 2014, the motion to change venue was approved [docket entry 199]. The cases were transferred to the Court on May 9, 2014 [docket entry 206].

8. On May 30, 2014, this Court allowed the United States Trustee's motion to appoint a Chapter 11 trustee, and Stephen B. Darr was appointed trustee (the "Chapter 11 Trustee") on June 6, 2014 [docket entries 234 and 250] and continue to serve in that position.

9. After his appointment, the Chapter 11 Trustee and his advisors retrieved and reconstructed copies of the TelexFree written and electronic records seized by the federal authorities through a painstaking data analysis and recovery process. These records were used, along with other investigative tools, to determine the mechanics of the TelexFree Ponzi scheme and how transactions were processed and recorded. *Affidavit*, at ¶12 .

10. 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. *Affidavit,* at ¶13.

11. 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. *Affidavit* at ¶14.

12. 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 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"). Affidavit, at ¶15.

13. Accordingly, the issuance of credits to Participants represented an essential expense necessary to growing TelexFree's 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. *Affidavit,* at ¶16.

14. 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. *Affidavit,* at ¶17.

15. 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. *Affidavit,* at ¶18.

16. On March 17, 2014, the original due date for filing its 2013 federal income tax return, the records show that TelexFree attempted to pay its 2013 estimated tax electronically. That payment was rejected. On March 31, 2014, the records show that TelexFree successfully submitted a payment to the Service in the amount of $15,792,982 for tax year 2013. *Affidavit,* at ¶19.

17. On or about October 1, 2015, the Chapter 11 Trustee retained KPMG, LLP as tax accountants and advisors to prepare and file necessary original and amended tax returns [docket entry 619].

18. 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 a Ponzi scheme are tax deductible. *Affidavit*, at ¶21.

19. 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] *Complaint of Chapter 11 Trustee for Declaratory Judgment and Disallowance of Claim ("Complaint"),* at ¶33; *United States' Answer to Complaint of Chapter 11 Trustee for Declaratory Judgment and Disallowance of Claim and Counterclaim ("Answer"),* at ¶33; *Affidavit,* at ¶22.

20. 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 reportedly 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. *Affidavit,* at ¶23.

21. 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

[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 liability, in effect, sought a refund of $15,792,982. Affidavit, at f/n 1.

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 made up of three components: estimated taxes paid of $15,792,982, plus accrued interest of $55,318, less a $315,860 bad check penalty.[3] *Complaint* at ¶34; *Answer* at ¶34.

22. 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, issued a notice of deficiency for tax year 2013, and filed an administrative proof of claim in the amount of $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] *Complaint* at ¶35-37; *Answer* at ¶35-37.

23. 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. *Complaint* at ¶38; *Answer* at ¶38.

24. As with the 2013 return, the Service disallowed substantially all of the expenses claimed by the Chapter 11 Trustee on the 2014 return. *Complaint* at ¶41; *Answer* at ¶41.

25. 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

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

[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"].

administrative claim in the aggregate amount of $69,460,404 [as amended, the "Administrative Claim"]. *Complaint* at ¶42; *Answer* at ¶42.

26. 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. *Complaint* at ¶42; *Answer* at ¶42.

27. On or about March 7, 2018, the Chapter 11 Trustee filed amended tax returns for 2013 and 2014 (the "Amended Tax Returns").

28. The amended tax return for 2013 (the "Amended 2013 Return") reflected a taxable loss of $3,143,851. *Complaint* at ¶45; *Answer* at ¶45.

29. The amended tax return for 2014 (the "Amended 2014 Return") reflected a taxable loss of $535,594,148. *Complaint* at ¶46; *Answer* at ¶46.

30. The Chapter 11 Trustee prepared and filed these amended tax returns as additional information became available. The Service has taken no action respecting the Amended Tax Returns. *Affidavit,* at ¶33.

31. 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. *Affidavit,* at ¶34.

32. Tax Division Directive No. 137 recognizes the appropriateness of subordinating tax claims to the claims of investors who are victims of an illegal business. *Affidavit,* at ¶35.

33. 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"). *See Joint Discovery Plan and Rule 26(f) Certification* [docket entry 8 in Adv. Proc. No. 18-4091, f/n 2].

34. 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. Alternatively, if any tax is due the Complaint seeks a declaration that any such tax is not an administrative claim. *See Complaint.*

STEPHEN B. DARR AS TRUSTEE
OF THE ESTATES OF TELEXFREE,
LLC, TELEXFREE, INC. and
TELEXFREE FINANCIAL, INC.

By his attorneys,

Dated: October 19, 2018

/s/ Andrew G. Lizotte

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