Docket #0023 Date Filed: 11/9/2018

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MASSACHUSETTS

In Re:	)	Chapter 11
	)	
TELEXFREE, LLC,	)	Case No. 14-40987-MSH
TELEXFREE, INC., and	)	Case No. 14-40988-MSH
TELEXFREE FINANCIAL, INC.,	)	Case No. 14-40989-MSH
	)	
Debtors.	)	Jointly Administered
	)	
STEPHEN DARR, AS HE IS THE TRUSTEE OF THE CHAPTER 11 ESTATES OF EACH OF THE DEBTORS,	)	
	)	Adv. Proc. No. 18-04091
Plaintiff and Counterclaim Defendant,	)	Judge Melvin S. Hoffman
	)	
v.	)	
	)	
UNITED STATES OF AMERICA, DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE,	)	
	)	
Defendant and Counterclaim Plaintiff.	)	

UNITED STATES' COMBINED BRIEF IN SUPPORT OF ITS OPPOSITION TO TRUSTEE'S MOTION FOR PARTIAL SUMMARY JUDGMENT AND UNITED STATES' CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

THE DEFENDANT/COUNTERCLAIM PLAINTIFF UNITED STATES OF AMERICA, named and sued as the United States of America, Department of Treasury, Internal Revenue Service ("IRS"), submits this combined brief in support of its opposition to the *Motion by Chapter 11 Trustee for Partial Summary Judgment* (Doc. No. 12) as well as in support of the *United States' Motion for Partial Summary Judgment* that was filed contemporaneously with this brief.

1440987181127000000000008

Background

As an initial matter, please note that the only issues before the Court in these cross motions for partial summary judgment are (1) in the event that the government proves that the Trustee received a $15.5 million erroneous refund, whether the Trustee must return the $15.5 million to the United States outright as property belonging to the United States, or to the extent that $15.5 million cannot be returned to the United States for some legal reason, whether the erroneous refund made to the Trustee related to TelexFree, LLC's 2013 income tax year is afforded administrative expense status under 11 U.S.C. § 503; and (2) whether the government's request for payment of TelexFree, LLC's income tax liabilities for 2014, a post-petition tax year, is classified as an administrative expense. *See* Doc No. 14 at 9 ("… 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"). Thus, in deciding these motions for partial summary judgment, the Court should presume that these are legitimate debts, i.e., the Trustee received a $15.5 million erroneous refund and that TelexFree, LLC, has unpaid income tax liabilities for 2014. *id*. at n.5 ("The amount of the Service's claim, if any, is not relevant to the Chapter 11 Trustee's summary judgment motion."). Accordingly, the following facts are all that are necessary to decide these motions.

1. **The IRS made a $15.5 million erroneous refund to the Trustee, which was related to TelexFree, LLC's 2013 income tax year.**

The Debtor, TelexFree, LLC, made a payment towards its 2013 income taxes, in the amount of $15,792,982, on or about March 24, 2014.[1] *See* "United States' Statement of

[1] For the sake of brevity, the government is not setting forth all of the material facts in this background section and instead incorporates by reference the separately-filed statement of undisputed material facts submitted in support of the *United States' Cross Motion for Partial Summary Judgment*.

Undisputed Material Facts" ("USSOF"), which was submitted contemporaneously with this brief, at ¶ 35. TelexFree, LLC, did not file its 2013 income tax return at that time; rather, it filed for an automatic extension. *Id*. Then, on April 13, 2014, TelexFree, LLC, filed a petition for bankruptcy under Chapter 11 of the Bankruptcy Code (11 U.S.C.). *See* USSOF, at ¶ 36.

After being notified of the bankruptcy petition, the IRS placed a bankruptcy/litigation hold code on TelexFree, LLC's IRS accounts, including its account for the 2013 income tax year; the bankruptcy/litigation hold code should have prevented any tax refund from being automatically generated by the computer-system. *See* USSOF, at ¶ 38.

The Trustee filed an income tax return (Form 1120) for 2013 on behalf of TelexFree, LLC; the Trustee requested a refund in the amount of $15,858,111. *Id*., at ¶ 39. On or about December 9, 2016, the IRS selected the 2013 income tax return for examination. *Id*., at 40.

Nevertheless, despite the bankruptcy/litigation hold code that was put on TelexFree, LLC's IRS accounts, on or about December 26, 2016, the IRS issued a tax refund check to the Trustee in the amount of $15,532,440.39, related to TelexFree, LLC's 2013 income tax year. *Id*., at ¶ 41. This was a computer-generated refund (as opposed to a manual refund), which should have been prevented by the bankruptcy/litigation hold code. The $15.5 million tax refund should not have been sent to the Trustee as the IRS was still examining the 2013 income tax return. *Id*., at ¶ 42.

To protect its interest in the $15.5 million erroneous refund, the IRS filed a request for payment (Claim No 2987-1, Claims Registry) against the Estate. *Id*., at ¶ 43. On the request for payment, the IRS specifically stated that it was "entitled to recoup the mistakenly-refunded money with priority over all other claims, including other administrative-priority claims, whether based on the imposition of a constructive trust or other legal remedy." *Id*. Apart from the $15.5

million amount, the IRS is not seeking to have any other portion of the debto for 2013 classified as an administrative expense.

The Trustee agreed to hold the $15.5 million erroneous refund pending resolution of this dispute. *Id*., at ¶ 45. The government has asserted a counterclaim in this adversary proceeding to recover the $15.5 million erroneous refund. *Id*., at ¶ 46.

2. The income tax return for 2014 was due after the petition date.

On November 30, 2017, the IRS amended its request for payment to add an administrative expense for TelexFree, LLC's federal income tax liabilities for 2014. *See* USSOF, at ¶ 49. The Trustee had filed an income tax return (Form 1120) for 2014 on behalf of TelexFree, LLC, on July 6, 2017. *Id.*, at ¶ 47. Obviously, the 2014 income tax return was due after the petition date.

The Trustee then filed an amended Form 1120 for the 2014 income tax year, in which he claimed deductions for expenses that were incurred after the petition date. *Id.*, at ¶ 50.

The Trustee filed his motion for partial summary judgment seeking a declaration that the administrative expenses identified on the request for payment (Claim 2987-2, Claims Register) be treated as prepetition claims against the Debtor. The government has cross-moved for a declaration that should the Court find that the Trustee received an erroneous refund related to TelexFree, LLC's 2013 income tax year, then the Trustee must return the $15.5 million erroneous refund to the IRS outright, or in the alternative the erroneous refund should be afforded administrative expense status, and that any unpaid tax liabilities for TelexFree, LLC's income tax year 2014 are properly classified as an administrative expense. (This adversary proceeding does not involve the United States' willingness to subordinate its claims to any entity.)

Argument

1. The erroneous refund should be returned to the government outright, but at a minimum, it should be afforded administrative expense status.

The Trustee argues that the IRS's request that the Trustee return the $15.5 million erroneous refund should be classified as a prepetition unsecured priority claim and not afforded administrative expense status. *See generally* Doc. No. 14 at 10–14. He contends that the erroneous refund related to the 2013 income tax year cannot be an administrative expense because it was not a tax "incurred by the estate" under 11 U.S.C. § 503(b)(1)(B)(i), but was instead a tax liability of the Debtor falling under 11 U.S.C. § 507(a)(8). *See* Doc. No. 14 at 11. The Trustee concludes that 11 U.S.C. § 507(c) classifies the erroneous refund as an unsecured priority claim. *See* Doc. No. 14 at 11-14.

The Trustee's arguments misunderstand the nature of the government's cause of action against the Trustee for the erroneous refund—the government is not arguing that the erroneous refund is a "tax" incurred by the estate. Rather, the government maintains that the Trustee was not entitled to the erroneous refund so he was unjustly enriched by it and he is merely holding the erroneous refund subject to a constructive trust. The Trustee has in his possession funds that belong to the government (that have been segregated), which are not property of the estate, and he must return those funds to the United States. Accordingly, while the erroneous refund may not be a *tax* incurred by the estate, it is a *debt* incurred by the Trustee, so the government's cause of action for the erroneous refund is, at the very least, afforded an administrative expense status. In fairness, however, the erroneous refund should be returned to the government outright (and not shared pro-rata with other administrative expenses) because the Trustee is merely holding the government's property.

a. The Trustee was unjustly enriched by the erroneous refund, the funds are not property of the estate, and the Trustee is merely holding the government's property in constructive trust.

"An action to recover a tax refund is essentially an action for restitution … governed by principles of equity." *United States v. Reagan*, 651 F. Supp. 387, 389 (D. Mass. 1987); *see also United States v. Bell*, 818 F. Supp. 444, 448 (D. Mass. 1993). Because "the recipient of an erroneously issued tax refund" is "unjustly enriched" at the government's expense, the government is entitled to recover the erroneous refund.[2] *Bell*, 818 F. Supp. at 449. Thus, the cause of action to recoup the erroneous refund from the Trustee is not seeking to collect on a tax incurred by the estate. *See United States v. Frontone*, 383 F.3d 656, 660–61 (7th Cir. 2004) ("Suppose the [defendants] had no income and therefore paid no income taxes, but the IRS made a mistake and mailed them a check. The government would be entitled to the return of the money, but not because the [defendants] owed it any taxes. The ground would be unjust enrichment, since the [defendants] would have no right to retain money paid them by mistake."); *In re Naeem*, 515 B.R. 297, 299 (Bankr. E.D. Va. 2014) ("The IRS has no claim against the estate. Its only claim is against the debtor who mistakenly received the check and spent the money. It is a claim for unjust enrichment, not for a tax."); *Clark v. United States*, 63 F.3d 83, 87 (1st Cir. 1995) ("taxpayers who receive erroneous refunds owe the IRS 'because they have been unjustly enriched by it, not because they have not paid their taxes'") (quoting *O'Bryant v. United States*, 49 F.3d 340, 346 (7th Cir. 1995)).

[2] The government's "long-established right to sue for an erroneous refund … is independent of statutory authorization," even though Congress "provided statutory authority to sue in § 7405(b) of the Internal Revenue Code of 1954." *Reagan*, 651 F. Supp. at 388 (citing *United States v. Wurts*, 303 U.S. 414, 415-16 (1938)).

The equitable nature of the cause of action for an erroneous refund reflects the fact that an erroneous refund rightfully belongs to the government, i.e., erroneous refunds are the property of the government. *See United States v. McRee*, 7 F.3d 976, 981 (11th Cir. 1993) (en banc) (where the circuit court affirmed the defendants' conviction for conversion of government property involving an erroneously issued IRS refund check, rejecting "the argument that the government's property interest ceased as a matter of law upon [one of the defendant's] receipt of the check, and holding "that the government at all times retained a property interest in the proceeds of the *erroneously* issued United States Treasury check") (emphasis in original). Since the erroneous refund is property of the government, it is not property of the estate. *See e.g.*, *In re Winters*, 485 B.R. 375, 379–80 (Bankr. M.D. Tenn.), *rev'd and remanded on other grounds*, 503 B.R. 434 (B.A.P. 6th Cir. 2013) (where the court held that "the debtor held neither a legal or equitable interest in the erroneous refund, and therefore, it was never property of the estate"); *In re Lindsey*, 2009 WL 1608526, at *3 (Bankr. N.D. Ohio Jan. 28, 2009) (stating, "the erroneous 2005 tax refund was not property of the bankruptcy estate. Rather, it was a postpetition payment mistakenly paid to the debtor, which the IRS later recovered…. 11 U.S.C. § 541 casts a broad net; however, it does not extend to property which does not belong to the debtor.").

Because "proceeds from [an] erroneously issued IRS refund check represent[] government property," *McRee*, 7 F.3d at 983, an individual holding such proceeds does so subject to a constructive trust. "A constructive trust may arise whenever a party obtains property which does not belong to him, and which he cannot in good conscience withhold from another who is beneficially entitled to it." *United States v. Augspurger*, 452 F. Supp. 659, 668 (W.D.N.Y. 1978), *amended by* 477 F. Supp. 94 (W.D.N.Y. 1979) (citations and internal quotations omitted); *see also United States v. Hart*, 12 F. Supp. 596, 597 (E.D. Pa. 1935), *aff'd*

sub nom., 90 F.2d 987 (3d Cir. 1937) ("Upon the receipt of money paid in mistake of law which under the circumstance it is inequitable to retain, a constructive trust in favor of the payer arises.").

The principle that the Trustee is merely holding the $15.5 million erroneous refund in a constructive trust is demonstrated by *In re Campbell*, 1990 WL 284750, (Bankr. D. Colo. Dec. 6, 1990). There, the United States sought "to recover an erroneous refund made to the [d]ebtor who, thereafter, turned the funds over to the [t]rustee" and the trustee was holding the funds in escrow. *Id*. at *1. The Trustee sought to dismiss the complaint arguing that 11 U.S.C. § 507(c) controlled and "that the IRS [was] not entitled to return of the entire amount but [was] only entitled to be paid as a claimant in the estate at the same priority as the tax claim upon which the erroneous refund was allegedly paid." *Id.* at *2. The *Campbell* court rejected this argument on the basis that the money held by the Chapter 7 trustee belonged to the United States. *Id*. at 2-3 ("The IRS paid the debtor its money in error…. [T]he debtor did not owe the government money. The United States had no claim against the debtor. The money that it, for lack of a better term 'refunded' to the debtor was its money."). Likewise, here, the Trustee is holding the erroneous refund—the government's money—and he must return it. *See* USSOF, at ¶ 45.

b. If the erroneous refund is not returned outright to the government, then it should be treated as an administrative expense.

Moreover, the Trustee is the party that was unjustly enriched by the erroneous refund because he received it. *See Frontone*, 383 F.3d at 660 ("the IRS's claim for the erroneous rebate issued to someone who actually owed no taxes would be a claim for restitution rather than a tax"). Thus, any liability for the erroneous refund lies against the Trustee, not the Debtor. Therefore, the debt is properly classified as an administrative expense under § 503, if for some reason the property cannot be returned.

Section 503(a) allows entities to file "request for payment of an administrative expense…." While subsection (b) provides types of administrative expenses, the list is not exclusive. *See* 11 U.S.C. § 503(b) ("there shall be allowed administrative expenses … including"); *also* 11 U.S.C. § 102(3) ("'includes' and 'including' are not limiting"). The types of administrative expenses specifically listed under subsection (b) supports the government's position, however.

For instance, § 503(b)(1)(B)(ii) identifies erroneous "quickie refunds" that "the estate received" as an administrative expense. And, taxes that are incurred by the estate, i.e., incurred post-petition, are also administrative expenses under § 503(b)(1)(B)(i). To be clear, the government is not suggesting that the erroneous refund at issue in this case was an erroneous "quickie refund" under § 503(b)(1)(B)(ii) or a post-petition tax under § 503(b)(1)(B)(ii). But, for the same reasons that such expenses are administrative expenses—the estate receives the refund and the liability was incurred post-petition—the erroneous refund at issue in this case should also be classified as an administrative expense because it is an obligation of the Estate.

Moreover, the erroneous refund received by the Trustee would unfairly harm the Debtor if the erroneous refund were treated as a priority claim against the Debtor under §§ 507(a)(8) and 507(c). TelexFree, LLC, had paid the $15.5 million towards its income tax debt for 2013; but, in requesting and receiving the erroneous refund, the Trustee created a larger tax deficiency for the tax year. It would be inequitable if, upon the Trustee receiving the erroneous refund, the Debtor were made liable for more prepetition tax debt because of what the Trustee received. Indeed, the additional prepetition priority tax debt that did not exist as of the date of the petition could be non-dischargeable.

Putting a hypothetical individual Chapter 7 debtor "into the shoes" of TelexFree demonstrates the inequities. Imagine an individual that had paid $15.5 million towards his 2013 income taxes, but did not file his 2013 income tax return. The Chapter 7 debtor files for bankruptcy protection in 2014. The Chapter 7 trustee files the individual's 2013 tax return and claims a refund of the $15.5 million. The IRS erroneously issues the refund to the Chapter 7 trustee and the trustee then uses the refund to pay creditors and administrative expenses of the estate. If the erroneous refund were treated as a prepetition priority tax claim against the Chapter 7 debtor, then the individual would emerge from bankruptcy with a non-dischargeable $15.5 million tax debt for a prepetition tax year, which did not exist prior to the petition date.

Thus, the government is not a "creditor," as that term is defined by the Bankrtupcy code, of TelexFree, LLC, with respect to the erroneous refund. "The term 'creditor' means … an entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor …." 11 U.S.C. § 101(10). On the date that the petition was filed, the IRS did not have a claim against the Debtor for the $15.5 million erroneous refund because TelexFree had paid the $15.5 million towards its 2013 income taxes. It was not until the Trustee, as an assignee under 11 U.S.C. § 541 of any claim for refund, solicited and then received the erroneous refund that the debt arose. *See Campbell*, 1990 WL 284750, at *2 (entering judgment against the Chapter 7 trustee for an erroneous refund).

c. Section 507(c) does not apply because the Trustee received the erroneous refund.

The Trustee argues that the $15.5 million erroneous refund is not an administrative expense because 11 U.S.C. § 507(c) controls.[3] Section 507(c) provides, in pertinent part, "a *claim* of a governmental unit arising from an erroneous refund or credit of a tax has the same

[3] The Trustee does not contend, nor could he, that § 507(c) somehow controls whether a constructive trust should be imposed upon the segregated erroneous refund.

priority as a claim for the tax to which such refund or credit relates." (Emphasis added.) In this case, the erroneous refund relates to the income tax year 2013, which would be a prepetition priority tax claim. *See* 11 U.S.C. § 507(a)(8)(A)(i). However, the government's right to payment for the erroneous refund is not against the Debtor—the government's right to payment is against the Trustee. As the assignee of the debtor under 11 U.S.C. § 541, the Trustee filed the claim for refund (Form 1120), and more importantly, the Trustee received the erroneous refund. Thus, the government is not asserting a "claim" for an erroneous refund as that term is used by § 507(c); rather, the government is seeking an "expense" for an erroneous refund incurred by the Trustee under § 503(b).

The distinction between prepetition "claims" and post-petition "expenses" is recognized by 11 U.S.C. § 507(a), which addresses both "expenses and claims." Section 507(a) enumerates nine categories of "claims," all of which arise prepetition. *See* 11 U.S.C. 507(a)(1) and (3)-(10). It also includes one category of "expenses"—allowable "administrative expenses," 11 U.S.C. § 507(a)(2)—such as fees for professional services in administering the estate, 11 U.S.C. § 503(b)(1)(A), all of which necessarily arise post-petition. "The dual reference to 'expenses and claims' appears to be no accident, given that the language constitutes a significant change in language from that used in the former Bankruptcy Act." Sidney Levinson, *Does an Administrative Expense Constitute a "Claim,"* 25 Cal. Bankr. J. 389, 392 (2000); *see also* S. Rep. No. 1106, 95th Cong., 2d Sess. 20 (1978) ("The committee amendments contain several changes designed to clarify the distinction between a 'claim' (which generally relates to a debt incurred before the bankruptcy petition is filed) and an administrative expense (which is an expense incurred by the trustee after the filing of the petition)."). Thus, because § 507(c)

specifically identifies a "claim of a governmental unit arising from an erroneous refund," this subsection is referring to a prepetition erroneous refund received by the debtor.

The cases cited by the Trustee in support of his position that § 507(c) controls—*Motor Freight Exp.*, *Scrap Disposal, Inc.*, and *Frontone*—are distinguishable on the basis that in each of those cases, the debtors (or debtors-in-possession), i.e., the actual taxpayers, were the parties that received the erroneous refunds, whereas here, the Trustee solicited and received the erroneous refund. Note, that in the *Motor Freight Exp*. case, the court disposed of the case in such a way so as to avoid the government's argument that the debtor had tortiously converted the erroneous refund even after the court recognized that "property stolen or improperly received … during a bankruptcy cannot be retained … on the ground that it is property of the estate," *In re Motor Freight Exp.*, 91 B.R. 705, 712 (Bankr. E.D. Pa. 1988).

In *Motor Freight Exp.*, the court had issued an unpublished opinion, following an evidentiary hearing on a claim objection, that the IRS's claim for an erroneous refund would be treated as a priority claim under §§ 507(a)(7) and 507(c), and not as an administrative expense. *See id*. at 707; *also In re Motor Freight Exp.*, 1988 WL 47601, at *2-3 (Bankr. E.D. Pa. May 11, 1988). The court then held a trial on a separate adversary proceeding brought by the IRS against the debtor to "establish the rights of the IRS to certain erroneous refund checks issued by the IRS to the [d]ebtor, [Motor Freight Express]." *Motor Freight Exp.*, 91 B.R. at 707. The court decided to treat the adversary proceeding as a request for reconsideration regarding its earlier order classifying the IRS's claim and found that there was no "cause" or "equitable reason" to reconsider its order. *Id*. at 709-11. In the alternative, the *Motor Freight Exp.* court stated that even if there were no such procedural hurdle, the IRS had "failed to support its contentions by any evidence that the disputed refund checks in issue were in fact ever paid…." *Id*. at 712. And,

"[i]f these checks were in fact never negotiated, the [erroneous refund] sum for which they were drawn must still be in the United States Treasury." *Id*. Accordingly, the *Motor Freight Exp.* court found, in the alternative, that there was no evidence that an erroneous refund was even made.

Still, the court recognized that "property stolen or improperly received by a debtor during a bankruptcy cannot be retained by a debtor on the ground that it is property of the estate," *id*. at 712, but the court had, in previous cases, "expressed [its] distaste for a creditor's contentions that it is required to receive favored treatment in distribution of estate assets due to the argument that certain funds of the debtor should be found to be held in trust by a claimant," *id*. at 713. The *Motor Freight Exp.* court avoided "choosing between these conflicting policies … in making a decision on the merits" by finding that the IRS had not proven that an erroneous refund was actually made. *Id*. Thus, *Motor Freight Exp.* does not actually support the Trustee's positon because, ultimately, the court held that there was no erroneous refund—thereby avoiding the very questions that are now before this Court. Here, there is no dispute that the Trustee solicited, received, and is currently holding the $15.5 million erroneous refund and those funds have been segregated by the Trustee.

The Trustee contends that *Motor Freight Exp.* stands for the proposition that § 507(c) controls "irrespective of when the error is discovered or the 'erroneous payment' is made" *see* Doc No. 14 at 13 (quoting *Motor Freight Exp.*, 1988 WL 47601, at *2); however, this ignores the most crucial facts: who received and who is holding the erroneous refund. In *Motor Freight Exp.*, the debtor was the recipient of the erroneous refund. *See* 91 B.R. at 707. Presumably, the Trustee contends that *Motor Freight Exp*. is analogous because the debtor was actually a debtor-in-possession when it received the refund. But the debtor versus debtor-in-possession is a

distinction without a difference given the equitable nature of the erroneous refund cause of action. That is, it is a legal fiction that the debtor and the debtor-in-possession are separate entities—they are both the same "taxpayer" and the same entity that received the erroneous refund. The equitable nature of the erroneous refund cause of action looks to who is holding the government's property. In this case, it is the Trustee, not the Debtor that received the erroneous refund.

The other two cases cited by the Trustee to support his contention that § 507(c) controls are also distinguishable because they involved erroneous refunds that were given to the debtors prepetition. In *Scrap Disposal*, the court determined that the debtor should have been taxed at a higher rate in 1978-1979, which the court treated as an "erroneous refund," that occurred before the debtor filed for bankruptcy protection in 1980. *In re Scrap Disposal, Inc.*, 24 B.R. 178, 180 (Bankr. S.D. Cal. 1982), *aff'd*, 38 B.R. 765 (B.A.P. 9th Cir. 1984). As the debtor was the party that was undertaxed, it was the recipient of the "erroneous refund." Similarly, in *Frontone*, the debtors received an erroneous refund and *then* filed for bankruptcy. *United States v. Frontone*, 383 F.3d 656, 657 (7th Cir. 2004).

In contrast, here, TelexFree, LLC, did not receive the erroneous refund nor did it "underpay its taxes" with respect to the erroneous refund. Rather, the Debtor paid the $15.5 million towards its 2013 income taxes, but the Trustee, as an alleged assignee of the debtor, sought and received the erroneous refund.

Moreover, all three of the cases cited by the Trustee are also distinguishable on the basis that the debtors/debtor-in-possession no longer had the funds resulting from the erroneous refunds. Here, the Trustee is holding the erroneous refund in a separate account. *See* USSOF, at ¶ 45. The erroneous refund is directly traceable—and as noted above, the erroneous refund is the

government's property (not the property of the estate) and the Trustee must return it. Thus, this case is far more like the situation presented in *Campbell*, 1990 WL 284750, and the Court should apply that reasoning to require the Trustee to return the government's property.

Furthermore, the inequities of the Trustee's argument that the erroneous refund should be treated as an unsecured priority claim is best demonstrated by the absurd result of such a classification. It would be absurd, if the Trustee were permitted to solicit and then receive an erroneous refund, which the government proved the Trustee was not entitled to, but then the Court allowed the Trustee to pay all of the administrative expenses of the estate, including the his own fees, out of the government's money before returning it. That is not an equitable result. Thus, if the government proves that the Trustee received an erroneous refund, then the Trustee is merely holding the money in constructive trust for the government, and he should return the $15.5 million outright without diminishing the value of the government's property by taking out administrative expenses.

In sum, the Trustee received the $15.5 million erroneous refund post-petition, so he was the party unjustly enriched by the erroneous refund at the government's expense; thus, any action to collect on the erroneous refund is, at a minimum, an action to collect on a debt incurred by the Trustee, which is a debt entitled to an administrative expense status. *See In re Munce's Superior Petroleum Prod., Inc.*, 736 F.3d 567, 568 (1st Cir. 2013) (and First Circuit cases cited therein) (holding that fines incurred post-petition were administrative expenses); *also Reading Co. v. Brown*, 391 U.S. 471, 485 (1968) (holding damages incurred because of the receiver's negligence is an administrative expense).

2. The request for payment for the unpaid income taxes for 2014 is afforded administrative expense status because it is a post-petition tax year.

The Trustee argues that IRS's request for payment of unpaid income taxes for 2014 should be classified as a "prepetition unsecured claim" and not an administrative expense. *See generally* Doc. No. 14 at 15–19. He contends, in essence, that the 2014 taxes were not incurred by the Estate because the income giving rise to the taxes was generated prepetition. *Id*.

This argument ignores the 2005 amendment to 11 U.S.C. § 507(a)(8)(A), however, which made it clear that "[w]here a Chapter 11 petition is filed during a taxable year, the tax on all income for that taxable year—without regard to whether the income was earned before or after the petition date—is considered a post-petition tax debt that is incurred by the estate." *In Re Earl Gaudio & Son, Inc*, 2017 WL 377918, *5 (Bankr. C.D. Ill. 2017) (involving Illinois state-income taxes); *see also In re FR & S Corp*., 2011 WL 1261329 (Bankr. D.P.R. 2011). While the Trustee suggests that the income tax liabilities for 2014 should be treated as a "prepetition unsecured claim," he does not explicitly identify how that claim should be classified, i.e., as a priority or general unsecured claim. In recognizing that § 507(a)(8)(A) now prohibits a priority claim for income taxes for a tax year ending post-petition, the Trustee implicitly argues that the income tax liabilities for 2014—a post-petition tax year—should be treated as a general unsecured claim. This simply cannot be the result intended by Congress in amending § 507(a)(8)(A).

Furthermore, federal income taxes are "incurred" on the last day of the tax year. *See In re Pac.-Atl. Trading Co.*, 64 F.3d 1292, 1301 (9th Cir. 1995) ("The pertinent legislative history clearly demonstrates that the drafters of § 503(b)(1)(B)(i) intended that a tax on income should be treated as 'incurred' on the last day of the taxable period."). Thus, TelexFree, LLC's 2014 income taxes were incurred on December 31, 2014—well after TelexFree, LLC, had filed its Chapter 11 bankruptcy petition (and after the Trustee became responsible for filing the Debtor's

income tax return, *see* 26 U.S.C. §§ 6012(b)(3) and 1399). Accordingly, the 2014 income taxes were "incurred by the estate" under 11 U.S.C. § 503(b)(1)(B).

a. Congress amended § 507(a)(8)(A) to make it clear that income taxes for post-petition tax years should be treated as administrative expenses.

Taxes are afforded administrative expense status if they meet two requirements: (1) the taxes were incurred by the estate, and (2) the taxes not a kind of tax specified in 11 U.S.C. § 507(a)(8). *See* 11 U.S.C. §§ 507(a)(8) and 503(b)(1)(B). Section 507(a)(8) identifies prepetition income tax claims that are afforded eighth priority status (often referred to as "unsecured priority claims"), e.g., prepetition income taxes that had a tax return due within three years of the petition date, prepetition income taxes assessed within 240 days before the petition date, and prepetition income taxes not assessed but assessable after the petition date. *See* 11 U.S.C. §§ 507(a)(8)(A)(i)-(iii).

Before 2005, the Trustee may have argued that the claim for the 2014 income tax year should be bifurcated according to prepetition income and post-petition income. In the 1990s, some of the circuit courts held that, in a corporate Chapter 11 case, a claim for the tax year in which the petition was filed (i.e., a "straddle year") should be bifurcated. *See*, *e.g.*, *In re Hillsborough Holdings Corp.*, 116 F.3d 1391 (11th Cir. 1997); *In re Pacific–Atlantic Trading Co.*, 64 F.3d 1292 (9th Cir. 1995); *In re L.J. O'Neill Shoe Company*, 64 F.3d 1146 (8th Cir. 1995). When those opinions were issued, 11 U.S.C. § 507(a)(8)(A), which was previously codified at § 507(a)(7), referred to "a tax on or measured by income or gross receipts." There was sufficient ambiguity in § 507(a)(7) (now 507(a)(8)), that the circuit courts allowing bifurcation were able to read the statute as applying to a tax year ending post-petition so long as the income giving rise to the taxes was earned pre-petition. *See*, *e.g.*, *Hillsborough Holdings Corp.*, 116 F.3d at 1394 ("we can assume for purposes of this appeal that the entire year's taxes

were incurred by the estate, but we still have difficulty accepting the Government's argument that the unpaid taxes are not 'of a kind specified in section 507(a)(7)'"); *In re Pac.-Atl. Trading Co.*, 64 F.3d 1292, 1304 (9th Cir. 1995) ("Even though the taxes were 'incurred by the estate' … the plain meaning of the phrase 'not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case,' persuades us that the 1988 tax claim fits squarely within the definition of § 507(a)(7)(A)(iii) and is therefore not an allowable administrative expense.").

However, the Bankruptcy Abuse Prevention Consumer Protection Act of 2005 ("BAPCPA"), amended § 507(a)(8)(A) to read "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." With that amendment, the reasoning that allowed bifurcation in pre-2005 cases no longer applied—the BAPCPA made it clear that income taxes for a post-petition tax year do not fall under § 507(a)(8). *See 4 Collier on Bankruptcy*, para. 503.07 (16th 2018) ("The 2005 Act resolved this conflict by amending section 507(a)(8) to make it clear that income and gross receipts taxes for the entire straddle year are postpetition taxes entitled to administrative priority."); *also In re FR & S Corp.*, 2011 WL 1261329, at *4 ("the income and gross receipts tax claims for straddling tax years are excluded from eighth priority status after the BAPCPA amendments"). Obviously, the Trustee's reliance on cases before 2005 that pre-date the BAPCPA is misguided.

Since income taxes for a post-petition tax year cannot be classified as priority claims under § 507(a)(8), then if the Court were to accept the Trustee's argument, the claim for the 2014 income taxes would have to be classified as a general unsecured claim. Surely, Congress did not intend such a result in amending § 507(a)(8)—it is illogical to conclude that in making it clear that taxes for post-petition tax years should not be treated as claims under § 507(a)(8), Congress

actually intended such taxes to have an even *lower* priority and be treated as general unsecured claims.

b. The 2014 income tax liabilities were incurred (and accrued) on December 31, 2014, after the Debtor filed its Chapter 11 bankruptcy petition.

Nevertheless, the Trustee implicitly argues that the 2014 income tax should be treated as a general unsecured claim because he contends that the taxes were not "incurred by the estate." He asserts that "the 'clear weight of authority' holds that for purposes of Section 503(b)(1)(B), federal income taxes are incurred at the time the taxes accrue, rather than when taxes become due." Doc. No. 14 at 15. This is a nonsensical argument, however, because the incurred-date contemplated by the Bankruptcy Code and accrual-date set out in the Internal Revenue Code are the same for federal income taxes.

Federal income taxes are "incurred" on the last day of the tax period. *See In re Pac.-Atl. Trading Co.*, 64 F.3d 1292, 1300 (9th Cir. 1995) (reviewing the legislative history of the Bankruptcy Code and concluding, "[w]e are persuaded that it is equally apparent from these statements that, in the absence of an explicit definition, Congress intended for a tax on income to be considered 'incurred' on the last day of the income period"); *also Matter of Interco Inc.*, 143 B.R. 707, 712 (Bankr. E.D. Mo. 1992), *aff'd sub nom*. *In re L.J. O'Neill Shoe Co.*, 64 F.3d 1146 (8th Cir. 1995) ("Congress reiterated that 'for purposes of the priority rules, a tax on income for a particular period is to be considered 'incurred' on the last day of the period.'").

This principle comports with the method for computing federal income taxes under the Internal Revenue Code, which states that "[t]axable income shall be computed on the basis of the taxpayer's taxable year," defining "taxable year," in pertinent part, as "the taxpayer's annual accounting period, if it is a calendar year or a fiscal year," and "calendar year" as "a period of 12 months ending on December 31." 26 U.S.C. §§ 441(a) and (b)(1) and (d). Thus, under the

Internal Revenue Code, taxes are "computed," which is to say the taxes "accrue," on the last day of the tax year. Thus, even if the Court were to accept the Trustee's contention that income taxes are "incurred" when they "accrue," that would still be the last day of the tax period, which with respect to the 2014 income taxes was on December 31, 2014—well after the petition date.

Moreover, the Trustee's argument that the income taxes were fixed prepetition because the Debtor stopped earning revenue after filing the bankruptcy petition ignores half the equation in determining a tax liability, i.e., expenses that may be claimed as deductions to reduce the net income. *See In re Int'l Match Corp.*, 79 F.2d 203, 205 (2d Cir. 1935) ("The amount of the 1932 tax could not possibly be determined by any one until January 1, 1933. Not until then could possible changes in the capital structure affecting the amount of the tax be known."). That is why federal income tax liabilities do not accrue until the last day of the tax period—the income tax liability cannot be fixed until the all of the income and expenses for the tax year are known. For example, here, the Trustee claimed deductions on the 2014 amended income tax return that he filed on behalf of TelexFree, LLC, for expenses that were purportedly incurred post-petition. *See* USSOF, at ¶ 50. He sought to take deductions in the amounts of $2,140,637 and $3,896,209 for "Legal and Professional Fees" and "Consulting Expense," respectively, which he identified as "administrative expenses incurred by the bankruptcy Estates…." *Id*. Thus, it is disingenuous for the Trustee to suggest that the tax liabilities for 2014 were fixed prepetition when he himself is trying to take deductions for expenses that were incurred post-petition.

To be clear, the filing of a Chapter 11 bankruptcy petition by a non-individual (like TelexFree, LLC) does not create a separate taxable entity. *See* 26 U.S.C. § 1399. But Chapter 11 trustees for a non-individual debtor are required to file an income tax return for the debtor "whether or not … such business is being operated." *See* 26 U.S.C. § 6012(b)(3) ("In a case

where a receiver, trustee in a case under title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns"). Chapter 11 trustees' obligation to file for a non-individual debtor carry with it the obligation to pay the taxes, which makes post-petition taxes an administrative expense under § 503(b)(1)(B). *See Hall v. United States*, 566 U.S. 506, 522 (discussing the import of 26 U.S.C. § 6012(b)(3) and stating, "[i]n effect, Congress provided that the trustee in a corporate-debtor case may shoulder responsibility that parallels that borne by the trustee of a separate taxable entity"); cf. Holywell Corp. v. Smith, 503 U.S. 47, 53-54 (1992). Thus, "[i]n a non-individual [Chapter 11] case, all of the assets and income become part of the bankruptcy estate and all taxes incurred during the administration of the case, except those treated as unsecured priority claims under section 507(a)(8), are treated as administrative expenses." 4 *Collier on Bankruptcy*, para. 503.07 (16th 2018). Accordingly, the IRS's request for payment for the 2014 income taxes should be afforded administrative expense status.

Conclusion

For the foregoing reasons, the Court should deny the Trustee's motion for partial summary judgment and grant the government's cross-motion for partial summary judgment. The Court should declare that: (1) in the event that the government proves that the Trustee received an erroneous refund in the amount of $15,532,441, the Trustee must return the funds from the erroneous refund to the United States outright as property belonging to the United States, or to the extent that $15,532,441 cannot be returned to the United States for some legal reason, the

erroneous refund made to the Trustee related to TelexFree, LLC's 2013 income tax year is afforded administrative expense status under 11 U.S.C. § 503; and (2) any unpaid tax liabilities for TelexFree, LLC's 2014 income tax year are administrative expenses under 11 U.S.C. § 503 subject to any voluntary subordination that the United States agrees to collaterally.

Respectfully submitted,

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

/s/ Carl L. Moore
CARL L. MOORE
Trial Attorney, Tax Division
U.S. Department of Justice
P.O. Box 55
Washington, D.C. 20044
202-307-5892 (v)
Carl.L.Moore@usdoj.gov

CERTIFICATE OF SERVICE

I certify that on November 9, 2018, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system, which will send notification of such filing to all CM/ECF-registered participants.

/s/ Carl L. Moore
CARL L. MOORE
Trial Attorney, Tax Division
U.S. Department of Justice