Docket #0028 Date Filed: 11/29/2018

**UNITED STATES BANKRUPTCY COURT**
**DISTRICT OF MASSACHUSETTS**

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

**MEMORANDUM OF LAW IN SUPPORT OF OPPOSITION BY CHAPTER 11 TRUSTEE TO UNITED STATES' CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT**

The Chapter 11 Trustee respectfully submits this memorandum in support of his opposition to the United States' Cross-Motion for Partial Summary Judgment on Counts IV and V of the Complaint (the "Cross-Motion").

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**Introduction**

Section 507(c) of the Bankruptcy Code dictates that the Service's claim, if any,[1] arising from the 2013 Refund has the same priority as the tax for the year to which the refund relates – in this instance, the tax that is claimed to be due is for 2013, a prepetition year, and the Service therefore has a prepetition priority tax claim. The Service does not have any tax claim against the Estates on account of the 2013 Refund independent of the Debtors' tax liability for 2013. The Service's attempts to avoid the application of Section 507(c) by arguing that it does not have a tax claim but, rather, that it has an equitable right to recovery or an administrative claim fail because its equitable theories and administrative expenses constitute "claims" that fall squarely within the scope of Section 507(c). There is nothing in the equities of the case to support allowance of the Service's tax claim as an administrative claim since this result would be decidedly at odds with Congress' expressed intention to treat the claim as a prepetition tax claim. Therefore, denial of the Cross-Motion as to Count IV of the Complaint is required.

The Service's claim for 2014 should be treated as a prepetition tax claim because TelexFree's Ponzi operation was shut down by the government prior to the filing of these cases and there was no income generated by the Estates for 2014 subsequent to the Chapter 11 filings. Under these circumstances, the Service's claim for the prepetition portion of 2014 should be treated as a prepetition tax claim and the Cross-Motion should be denied as to Count V as well.

[1] In accordance with his duties, the Chapter 11 Trustee has filed original and amended tax returns for 2013 which reflect income earned by TelexFree from the Ponzi operation and expenses incurred by it. Paradoxically, the Service has rejected the return by, among other things, accepting the income but disallowing the expenses incurred in operating the scheme. For purposes of summary judgment only, the Chapter 11 Trustee accepts the Service's contention that there is a 2013 tax liability due to the Service.

## I. Argument

### A. Any right that the Service has against the Estates on account of the 2013 Refund constitutes a claim and is governed by 11 U.S.C. §507(c).

The Service's assertion that it has a right, equitable or otherwise, to return of the 2013 Refund constitutes a "claim" as set forth in 11 U.S.C. §101(5) and such claim is governed by Section 507(c). "Claim" is defined in Section 101(5) of the Bankruptcy Code to include: "(A) *right to payment*, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) *a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment*, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured." (emphasis added). Congress defined the term "claim" in the broadest possible terms and unambiguously stated its intention to address all possible legal obligations of the debtor. *In re Remington Rand Corp.*, 836 F.2d 825, 829 (3rd Cir. 1988). The breadth of the definition of claim is intended to ensure that the maximum relief can be afforded to a debtor. *In re Chateaugay Corp.*, 102 B.R. 335 (Bankr. S.D.N.Y. 1989).

The theories advanced by the Service for return of the 2013 Refund, i.e., unjust enrichment, restitution, and constructive trust, constitute "claims" under 11 U.S.C. §101(5). The overriding element of both unjust enrichment and restitution is a right to payment based upon a benefit conferred upon a party from whom payment is sought. *In re Snowcrest Dev. Group*, 200 B.R. 473, 480 (Bankr. D. Mass. 1996). The Service's claims for unjust enrichment and restitution are simply requests for recovery of money on equitable grounds, and any such alleged right to recovery is a "claim" in bankruptcy. *See, e.g., In re Eiseman*, 2013 Bankr. LEXIS 95 (Bankr. E.D. Wi. 2013) at *3 (unjust enrichment is a claim); *see also In re Hall*, 559

B.R. 456 (Bankr. W.D. Va. 2016)(same)*; Penn. Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 557-560, 110 S. Ct. 2126, 2130-31 (1990)(the plain meaning of a right to payment, or claim, is nothing more nor less than an enforceable obligation); *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589 (9th Cir. 1991)(restitution claim constitutes a debt, which is defined in the Bankruptcy Code as liability on a claim); *In re Bernard L. Madoff Sec. LLC*, 445 B.R. 206 (Bankr. S.D.N.Y. 2011)(restitution obligation constitutes a "debt"). Although constructive trust is an equitable remedy and not an independent basis for relief, it also constitutes a claim as set forth in 11 U.S.C. §101(5)(B) because it can be satisfied through repayment of the 2013 Refund. *See, e.g., Piccerelli v. Piccerelli (In re Piccerilli)*, 525 B.R. 184, 193 (Bankr. D. Mass. 2015)(assertion of a constructive trust is a claim and that claim should participate in the distribution of estate assets in the manner dictated by the Bankruptcy Code); *Shea v. Goldstein (In re Goldstein)*, 234 B.R. 214, 221 (Bankr. D. Mass. 1999)(same) *In re CRS Steam, Inc. v. Engineering Resources, Inc. (In re CRS Steam, Inc.)*, 225 B.R. 833 (Bankr. D. Mass. 1998)(same).[2] As further discussed in Section (B) *infra*, the term "claim" applies regardless of whether the claim arises prepetition or postpetition.

Because the Service's equitable theories of recovery constitute "claims", they are governed by the provisions of Section 507(c), which provides that: "for the purpose of subsection (a) of this section, a *claim* of a governmental unit *arising from* an erroneous refund or

[2] Further supporting the absence of any basis for a constructive trust, the Chapter 11 Trustee notes that the 2013 Refund was issued payable to TelexFree LLC c/o S. Darr Trustee in December 2016 and deposited into the Chapter 11 Trustee's general operating account. Nearly one year later and at the request of the Service, the Chapter 11 Trustee agreed to set aside the amount of the 2013 Refund, and not the 2013 Refund itself, pending the Court's resolution of this dispute. There is no allegation of fraud in the preparing and filing of the 2013 tax return, which is a necessary element for imposition of a constructive trust. *Dwyer v. Ins. Co. of the State of Pa (In re Pihl, Inc.)*, 529 B.R. 414 (Bankr. D. Mass. 2015), *citing Nessralla v. Peck*, 403 Mass. 757, 762, 532 N.E. 2d 685 (Mass. 1989).

credit of a tax has the same priority as a *claim* for the tax to which such refund or credit relates." (emphasis added). The Service seeks to render the term "claim" in Section 507(c) meaningless by attaching labels to its claim for the 2013 Refund. If the Service's argument was correct, i.e., that an erroneous refund can be recovered by the Service in any bankruptcy case simply by pleading equitable theories of recovery, then Section 507(c) would be rendered superfluous. *See Allende v. Shultz*, 845 F.2d 1111, 1119 (1st Cir. 1988)(a familiar canon of statutory construction cautions a court to avoid interpreting a statute in a manner so as to make part of the statute meaningless); *see also Montclair v. Ramsdell*, 107 U.S. (17 Otto) 147, 152, 2 S. Ct. 391 (1883)("it is the duty of the court to give effect, if possible, to every clause and word of a statute avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed"); *Adamowicz v. Ipswich*, 772 F.2d 5, 8 (1st Cir. 1985)(construction of a statute which leads to a conclusion that a piece of legislation is ineffective should not be adopted if the statutory language is capable of a construction that leads to a sensible result).

The Service cites to cases, and *dicta* within certain of those cases, in support of its various arguments, but these cases are either nonbankruptcy or are readily distinguishable from the case at bar. The nonbankruptcy cases cited by the Service [3] are not relevant because Section 507(c) does not have any application outside of a bankruptcy case. The Bankruptcy Code establishes a paradigm of debtor and creditor rights that does not exist in other settings, and the treatment and priority of claims is governed by it. Congress specifically addressed the priority of

[3] *See, e.g., United States v. Reagan*, 651 F. Supp. 387 (D. Mass. 1987); *United States v. Bell*, 818 F. Supp. 444 (D. Mass. 1993); *Clark v. United States*, 63 F.3d 83 (1st Cir. 1995); *O'Bryant v. United States*, 49 F.3d 340 (7th Cir. 1995); *United States v. McRee*, 7 F.3d 976 (11th Cir. 1993); *United States v. Augspurger*, 452 F. Supp. 659 (W.D.N.Y. 1978); *United States v. Hart*, 12 F. Supp. 596 (E.D. Pa. 1935).

claims of the Service in the Bankruptcy Code. Section 503(b)(1)(B) describes the types of tax claims that are entitled to administrative claim status, which the Service admits do not apply here as its claim is not for a tax incurred by the Estates pursuant to Section 503(b)(1)(B)(i) nor is it a claim based upon a "quickie refund" pursuant to Section 503(b)(1)(B)(ii). *See United States Combined Brief in Support of Opposition to Trustee's Motion for Partial Summary Judgment and United States Cross-Motion for Partial Summary Judgment ("Memorandum")*, at pp. 5, 9. Congress also specified the types of tax claims entitled to prepetition priority status for tax years ending prior to the petition date. 11 U.S.C. §507(a)(8). Congress further specifically provided for claims of the Service arising from erroneous refunds in Section 507(c) and accorded such claims the same priority as the tax for the underlying tax year. *In re Frontone*, 383 F.3d 656 (7th Cir. 2004). This comprehensive legislative framework is wholly absent outside of the Bankruptcy Code. Because Section 507(c) does not apply to non-bankruptcy cases, nor do the policies and principles governing debtor-creditor relations in bankruptcy apply in those situations, such cases are not relevant to the determination of the priority of the Service's asserted claim in this case.

The bankruptcy cases cited by the Service do not support its contention that it is entitled to payment of the 2013 Refund because they are wholly distinguishable. *In re Naeem*[4] hardly supports the Service's position because that case was not an erroneous refund case but, rather, involved an accurate refund that was misdelivered by the Service. The Service mistakenly paid a refund first to the chapter 7 debtor, who spent it, and the Service paid the refund, again, this time to the proper party, the chapter 7 trustee. Since the debtor did not owe any tax for the year to which the refund related, the court found that the Service did not have a claim against the estate.

[4] 515 B.R. 297 (Bankr. E.D. Va. 2014)

Unlike the facts in *Naeem*, here, the Service alleges that TelexFree owes tax for 2013, the refund was on account of the estimated tax payment made by TelexFree, and Section 507(c) applies by its terms.

*In re Campbell*[5] similarly does not support the Service's arguments. *Campbell* is not an erroneous refund case either. In *Campbell*, the debtor made tax payments which satisfied his tax obligation for that year. The Service then erroneously credited the debtor for a second time for the same tax payments (in effect treating the tax payments as having been made twice) and issued a refund to the trustee. In determining not to apply Section 507(c), the court relied upon the fact that the Service did not otherwise have a tax claim for the year in question, which the court found was a necessary element for application of Section 507(c). Here, the 2013 Refund represents the amount paid by TelexFree as an estimate against its tax liability for 2013 (it was not the Service's money, as in *Campbell*), and the Service has asserted a tax claim for 2013.

In *Frontone*, the Service issued an erroneous refund to a chapter 7 debtor prepetition and made an assessment against the debtor based upon the erroneous refund. The court held that the Service had a tax claim against the debtor on account of the erroneous refund that was nondischargeable based upon Section 507(c). In *dicta*, the *Frontone* court observed that under different circumstances, Section 507(c) might not apply – that is, if the debtor had no income and paid no income tax, and where the Service made a mistake and mailed the debtor a check. These are not our facts. Again, the 2013 Refund is on account of the estimated payment made by TelexFree prepetition and the Service asserts a claim for taxes due for 2013, and therefore its refund claim falls squarely within the ambit of Section 507(c).

[5] 1990 Bankr. LEXIS 2922 (Bankr. D. Col. 1990).

The Service's equitable theories of recovery constitute claims governed by Section 507(c). If no tax is determined to be due for 2013, the Estate is entitled to refund of the 2013 estimated tax payment. If the Service is owed money for 2013, the Service's claim for that year, including the claim it asserts for the 2013 Refund, constitutes a prepetition priority tax claim as specifically provided for in Section 507(c). In either event, the Service is not entitled to recover the 2013 Refund.[6]

**B. The claim of the Service arising out of the 2013 Refund is a prepetition tax claim and not an administrative claim.**

The Service does not have any claim on account of the 2013 Refund independent of its tax claim against the Debtor for 2013. As set forth in *Frontone*, the Service's claim for the 2013 Refund constitutes a tax. 383 F.3d at 662. There is no basis to treat the Service's claim as anything other than a tax claim because if the Service were to recover the 2013 Refund, it would have to apply those funds to TelexFree's tax liability. Assuming as we must for purposes of the motion that TelexFree has a tax liability for 2013, Congress specifically provided for that claim in Section 507(c) by giving the Service a claim on account of the 2013 Refund that is equivalent to the claim for tax liability for 2013. The Service's arguments that it is entitled to an administrative claim for the 2013 Refund are refuted by the plain language of Section 507(c).

Section 507(c) applies to all "claims" arising out of an erroneous refund. The introductory clause to Section 507(c)- "for the purpose of subsection (a) of this section…" - makes clear that, without exception, all claims for erroneous refunds, whether such claims arose

[6] Two bankruptcy cases cited by the government for the proposition that an erroneous refund is not property of the estate are distinguishable in that neither case even addressed the applicability of Section 507(c) and, in both instances, the funds in dispute had already been returned to the Service. *See In re Lindsey*, 2009 Bankr. LEXIS 2043 (Bankr. N.D. Ohio 2009); *In re Winters*, 485 B.R. 375 (Bankr. M.D. Tenn. 2013).

prepetition or postpetition, are governed by Section 507(c). Congress could have excluded postpetition refunds from the application of Section 507(c) but expressly did not. The term "claim" is extremely broad and applies to rights arising both prepetition and postpetition. *In re WorldCom, Inc.*, 401 B.R. 637 (Bankr. S.D.N.Y. 2009). As described in *WorldCom:*

> ..an entity with a right to payment against the estate has a claim. The timing of when that right to payment arose does not affect its status as a claim under the Code but rather the timing only affects whether the claimant must file a proof of claim or a request for an administrative expense. Therefore, even though the OneStar Trustee's right to payment did not arise prepetition, it is still a claim against the estate subject to treatment under the Code, *such as classification as an administrative expense*. (emphasis added)
> *Id*. at 643.

The broad definition of claims in the Bankruptcy Code includes of necessity post-petition obligations incurred by a trustee or debtor-in-possession. *Snider v. Commercial Fin. Servs. (In re Commercial Fin. Servs.)*, 252 B.R. 516, 525 (Bankr. N.D. Okla. 2000). Administrative expenses are merely a subset of "claims". *In re Circuit City Stores, Inc.*, 426 B.R. 560, 568 (Bankr. E.D. Va. 2010).[7] Throughout the Bankruptcy Code and decisional law, the terms "claim" and "expense" are used interchangeably. *See In re Javed*, 2018 Bankr. LEXIS 3135 (Bankr. D. Md. 2018) at *6, f/n 7 (courts generally view administrative expenses as a kind of claim in a bankruptcy case; Section 503(b) identifies permissible administrative expense claims); *In re Powermate Holding Corp.*, 394 B.R. 765, 772 (Bankr. D. Del. 2008)(there are nine types of claims that may receive administrative expense status); *In re Tristar Fire Prot., Inc.*, 466 B.R. 392, 401 (Bankr. E.D. Mich. 2012)(503(b) contains nine separate subparagraphs, each describing

[7] *Circuit City* goes on to state:
Throughout the Bankruptcy Code, the term "claim" is used to refer to administrative expenses. For example, under §1123(a), "a plan shall (1) designate, subject to section 1122 of this title, classes of claims, other than claims of a kind specified in section 507(a)(2)."…Section 507(a)(2) specifically refers to "administrative expenses allowed under section 503(b) of this title…" So, the kind of "claims" specified in §507(a)(2) to which §1123(a) refers are administrative expenses. *Id*. at 568.

a category of claims entitled to administrative expense priority). Given the express language of Section 507(c) which applies to any and all claims as provided for in Section 507(a), the breadth of the term "claim" and its applicability to postpetition as well as prepetition rights of recovery, it is clear that Section 507(c) includes by its plain language refunds issued postpetition.

Section 507(c) make clear that a taxing authority that issues a postpetition refund relating to a prepetition tax year shall have a prepetition tax claim on account of such refund. The same result follows from Section 502(i) of the Bankruptcy Code which provides that:

> A claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e), the same as if such claim had arisen before the date of the filing of the petition.

The primary purpose of Section 502(i) is to differentiate between a priority tax and an administrative tax, focusing on when the liability was incurred rather than when the tax became due. *See, e.g., In re Turner*, 420 B.R. 711, 715-16 (Bankr. E.D. Mich. 2009); *In re Blue Lustre Prods.*, 214 B.R. 188 (S.D. Ind. 1997); *In re Felland*, 153 B.R. 835 (Bankr. W.D. Wis. 1993). The Service's claim on account of the refund is based upon the Debtors' alleged tax liability for 2013. Section 502(i) provides that such claim shall be allowed as if the claim had arisen prior to the petition date. The Service's attempt to establish an administrative claim against the Estates is in clear contravention of Sections 507(c) and 502(i). Contrary to the clear and unambiguous provisions of Sections 507(c) and 502(i), the Service has not cited to any specific statute in support of its claim other than Section 503(b) which must be construed narrowly in granting administrative claim status. *In re Hemingway Transp.*, 954 F.2d 1, 4-5 (1st Cir. 1992).

The Service's contention that it is somehow entitled to an administrative claim because the Chapter 11 Trustee, rather than the Debtors, filed the 2013 return is without merit. The 2013 tax return is a prepetition return required to be filed by the Chapter 11 Trustee as part of his

duties as the representative of the TelexFree Estates,[8] not as an "assignee" of TelexFree as contended by the Service. *Memorandum,* at p. 10. The tax return was filed in the name of TelexFree, and the refund was issued to TelexFree. The Service's attempts to draw a distinction between a refund delivered to a trustee and one delivered to a debtor-in-possession is meaningless, as a trustee serves substantially the same role as a debtor-in-possession. Section 1107(a) of the Bankruptcy Code makes clear the nearly identical roles of a debtor-in-possession and a trustee:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

*In re Motor Freight Express*, 1988 Bankr. LEXIS 2608 (Bankr. E.D. Pa. 1988) involved the application of Section 507(c) under facts substantially similar to those presented here. In that case, the Service issued an erroneous refund postpetition to the Chapter 11 debtor-in-possession on account of a prepetition tax year. While the Service contended that the debtor's failure to return the refund elevated the status of its claim to an administrative claim, the court, relying upon Section 507(c), granted the Service a prepetition priority claim. The Court should reach the same conclusion in this case, as the trustee performs the same role as a debtor-in-possession.[9]

Nor should the equities of the case come into play in determining whether the Service has an administrative claim, where Sections 507(c) and 502(i) govern. A court's equitable discretion is limited and cannot be used in a manner that is inconsistent with provisions of the Bankruptcy

[8] See 11 U.S.C. §1106.

[9] The Service's citation to and discussion of *dicta* in *In re Motor Freight Express*, 91 B.R. 705 (Bankr. E.D. Pa. 1988) is wholly irrelevant, as that decision simply denied the Service's request for reconsideration of the earlier decision cited above.

Code. *In re Plaza de Diego Shopping Center, Inc.*, 911 F.2d 820, 830-31 (1st Cir. 1990). Thus, the equitable powers of a court are not a license to disregard the clear language and meaning of bankruptcy statutes and rules. *Offical Comm. Of Equity Sec. Holders v. Mabey*, 832 F.2d 299, 302 (4th Cir. 1987). *See also Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S. Ct. 963 (1988)("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code"); 2 Collier on Bankruptcy P105.01[2], Resnick and Sommer, 15th Ed. Rev. 2005)(Section 105 does not permit the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code). To grant relief to the Service based upon equity where the statutory provisions are clear would be tantamount to judicial legislation. *In re Bell*, 700 F.2d 1053 (6th Cir. 1983); *see also Matter of Chicago, Milwaukee, St. Paul & Pacific Railroad*, 791 F.2d 524 (7th Cir. 1986)(a court of equity does not have free floating discretion to redistribute rights in accordance with its personal views of justice and fairness).

Even if consideration of the equities was appropriate, such equities weigh heavily in favor of the Chapter 11 Estates. The Debtors are defunct, nonoperating entities as well as corporate entities not entitled to, nor in need of, a discharge. 11 U.S.C. §1141(d)(3). The Service's reference to harm that might be suffered by an individual debtor as a result of an erroneous refund does not apply here. The estimated tax payment made by TelexFree was funded with victim's contributions to the Ponzi scheme. Those funds, which were the proceeds of fees paid by net losers, should be used to maximize the recovery for victims in this case. The tax year in question is undisputedly a prepetition tax year. To the extent that the Service has an allowed claim, such claim shall be treated and paid as a prepetition tax claim. The Service's

attempt to elevate its prepetition tax claim to administrative status would inflict further harm on TelexFree's victims.

**C. The Service is not entitled to an administrative claim for the alleged 2014 tax liability.**

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 the prepetition period in 2014 that has not been subordinated should be treated as a prepetition tax claim. As set forth in the *Chapter 11 Trustee's Memorandum of Law in Support of Motion for Partial Summary Judgment,* 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". 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); *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)." The Estates did not earn any income in 2014 postpetition, as all of the revenues generated in 2014 arose prior to the Petition Date.

TelexFree's tax liability for the prepetition portion of 2014 should be treated as a prepetition tax claim because that is when the income was earned. *See, e.g., In re O.P.M. Leasing Services, Inc.*, 68 B.R. 979, 985 (Bankr. S.D.N.Y. 1987)(liabilities of the estate do not penetrate the barrier of the petition date for purposes of imposing an administrative claim on income earned prepetition). Courts that have held that income tax liability is not incurred until

the last day of the tax year, *see, e.g., In re Earl Gaudio & Son, Inc.*,[10] fail to take into account the importance of separating prepetition and postpetition activity and are factually distinguishable from this case. Cases such as *Earl Gaudio* generally rely upon the fact that the debtor's 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 TelexFree as it ceased operating at the time of the bankruptcy filing, all of the revenues for the 2014 year were earned prepetition, and its prepetition tax liability is readily ascertainable.

Under the particular circumstances of this case, where the Debtors had been shut down prepetition, conducted no postpetition operations and generated no postpetition revenues for 2014, any tax claim incurred for the prepetition portion of 2014 should be treated as a prepetition claim. Accordingly, the Service is not entitled to an administrative claim for tax year 2014.

**D. Department of Justice Tax Directive 137 provides further support for treatment of the Service's claims as prepetition tax claims.**

Allowance of an administrative claim for the Service for 2013 or for the prepetition portion of 2014 appears to be in direct contravention of Department of Justice Tax Directive 137, which provides the following when there is a contest between tax claims and investor claims in connection with a Ponzi scheme:

> When there is no statutory lien for either the federal tax claim or the claim of the investor or victim, the Tax Division will examine both the origin of the claim and whether the investor or victim can trace the lost property to the fund at issue. When both the tax claim and the claim of the investor or victim arise from the same transaction and the investor or victim can trace its property to the fund in issue, the Tax Division will recognize the priority of the claim of the investor or victim." [11]

[10] 2017 Bankr. LEXIS 207 (Bankr. C.D. Ill. 2017)

[11] A copy of the directive is attached.

In this case, the Service's claims and the victims' claims arise from the same pool of money, as TelexFree had no legitimate business operations, and therefore the directive calls for subordination of the Service's claim to the payment of victims. The directive further provides that the Service should retain any rights to priority with respect to claims for taxes arising from administration of the insolvent estate or from the disposition of property held in constructive trust. The Service's claims are not for taxes incurred by the Estates nor the disposition of property by the Estates. As such, the Service's request for administrative claim status should be denied as it undermines the efforts of the Chapter 11 Trustee and all of the other federal agencies that have worked assiduously to effect a recovery for victims of TelexFree's fraudulent enterprise.

## II. CONCLUSION

For the reasons set forth above, the Court should deny the Cross-Motion, grant summary judgment in favor of the Chapter 11 Trustee on Counts IV and V of the Complaint, and grant such other relief as is just and proper.

Respectfully submitted,

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

Dated: November 29, 2018

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**DEPARTMENT OF JUSTICE**
**TAX DIVISION DIRECTIVE NO. 137**

**TAX CLAIMS AGAINST EMBEZZLERS, SWINDLERS, ETC.**
**v.**
**RECOVERY BY INVESTORS, DUPES, AND VICTIMS, ETC.**

Often the Government's tax claim against an embezzler or perpetrator of a swindle can be collected only by reducing possible recovery by the investor, dupe or victim.[*] Where there is no statutory lien for either the federal tax claim or the claim of the investor or victim, the Tax Division will examine both the origin of the claim and whether the investor or victim can trace the lost property to the fund at issue. When both the tax claim and the claim of the investor or victim arise from the same transaction and the investor or victim can trace its property to the fund in issue, the Tax Division will recognize the priority of the claim of the investor or victim.

When the tax claim and the claim of the investor or victim do not arise from the same transaction, the Tax Division will recognize the priority of the claim of the investor or victim when the investor or victim can trace his claim to the property at issue and either (a) title never passed to the wrongdoer, such as in the case of theft, or (b) when a constructive trust, including all tracing requirements, has been imposed prior to assessment of the tax, or would be imposed and the tax has not been assessed.

If a federal court has ordered restitution as part of a criminal case, the Division will evaluate the priority of the federal tax liens against the claims of investors and victims in accordance with federal law, including the *Mandatory Victims Restitution Act*, 18 U.S.C. § 3613, which creates a federal restitution lien for the benefit of the victims of wrongdoing (which includes both defrauded investors and victims of theft), and the *Federal Tax Lien Act*, 26 U.S.C. §§ 6321-6323. In general, the Tax Division will follow the principle of "first in time is first in right."

Claims for taxes arising from administration of a receivership or from disposition of property in constructive trust should be paid as an expense of administration, "on or before the due date of the tax." 28 U.S.C. § 960; *see also,* 26

[*] As used here, "investor" denotes a willing participant or customer who was misled or defrauded by the perpetrator, and includes "dupes" (see *Cunningham v. Brown*, 265 U.S. 1, 7 (1924)). "Victim" denotes a person who did not willingly participate or willingly part with money or property, such as when there is theft, including embezzlement.

U.S.C. § 6012(b)(3). Such administration expenses are generally paid ahead of other claims against the assets of the receivership. When a receivership is insolvent, the administrative tax claims may be entitled to priority pursuant to 31 U.S.C. § 3713.

A mere showing by opposing counsel that allowing the Government's tax claim would prejudice the investor or victim in some way is not sufficient grounds for concession. While there is room for negotiation, the above principles should guide your analysis and negotiation. These cases are particularly susceptible to resolution by compromise. Even when our position is legally correct, a court may nevertheless seek to uphold a constructive trust wherever possible, by relaxing tracing requirements or employing other means to hold in favor of a sympathetic investor or victim. Accordingly, consistent with a realistic evaluation of litigating hazards, we should endeavor to reach reasonable settlement in these cases, rather than presenting unsympathetic claims to the court.

Although Tax Division civil attorneys, paralegals and support staff are not "Employees of the Department of Justice" for purposes of the *Justice For All Act of 2004,* 18 U.S.C. § 3771 and regulations, 45 C.F.R. § 45.10(a), Tax Division civil attorneys, paralegals and support staff act in accordance with and uphold the spirit of the *Justice For All Act of 2004* when they act in accordance with this Directive (including any update or revision), and analyze a case under these principles.

Date: 11/3/2008

/s/ Nathan J. Hochman

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