Docket #0031 Date Filed: 12/10/2018

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.	)	

DEFENDANT/COUNTERCLAIM PLAINTIFF UNITED STATES' REPLY TO MEMORANDUM OF LAW IN SUPPORT OF OPPOSITION BY CHAPTER 11 TRUSTEE TO UNITED STATES' CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

The Defendant/Counterclaim Plaintiff United States of America hereby replies to the *Memorandum of Law in Support of Opposition by Chapter 11 Trustee to United States' Cross-Motion for Partial Summary Judgment* (Doc No. 28) (hereinafter referred to as the "Opposition Memo"). The government will not rehash the arguments it made in its brief in support of the government's cross-motion for partial summary judgment (Doc. No. 23), but rather submits this reply to address a few discrete points raised by the Trustee in his response.



1. The erroneous refund is not property of the estate and the cause of action to recover the erroneous refund is against the Trustee.

In his Opposition Memo, the Trustee appears to have missed the points raised by the government's discussion regarding the equitable nature of an action to recover an erroneous refund. The government made two broad points in discussing the equitable nature of the erroneous refund action: (1) the erroneous refund is not property of the estate and (2) an erroneous refund action is brought against the person who requested, received, and is holding the erroneous refund—in this case, the Trustee, which makes the right to payment for the erroneous refund an administrative expense.

Regarding this first point, the Trustee essentially ignores the government's argument that the $15.5 million erroneous refund is not property of the estate. Thus, the government will not repeat its argument, but rather refers the Court to its opening brief. *See* Doc. No. 23 at 6-8. The bottom line, however, is that neither the Debtor nor its estate had a "legal or equitable interest" in the erroneous refund that the Trustee received post-petition, *see* 11 U.S.C. § 541(a)—the money belongs to the government. *See*, *e.g.*, *Begier v. I.R.S.*, 496 U.S. 53, 67 (1990) (holding that trust fund taxes paid from the debtor's general bank accounts to the IRS were not subject to avoidance action because trust fund taxes are not "property of the debtor"). Any claim for refund belonged to the estate, not the Debtor. *See* 11 U.S.C. § 541(a). The presumption that we are operating under in these cross-motions for partial summary judgment is that the government will be successful in showing that the $15.5 million refund was erroneously-issued to the Trustee on behalf of the bankruptcy estate. Under this presumption, the Trustee was never entitled to a refund; the refund that the Trustee requested and received was erroneous. Therefore, the erroneous refund is not property of the estate because the bankruptcy estate did not have a legal or equitable interest in the erroneous refund at the commencement of the case. *See In re NTA,*

LLC, 380 F.3d 523, 528 (1st Cir. 2004) ("A bankruptcy estate cannot succeed to a greater interest in property than the debtor held prior to bankruptcy.").

Turning to the second point, the equitable nature of an erroneous refund cause of action shows that the Trustee is liable as he is the party that requested and received the erroneous refund. And because the cause of action is against the Trustee as a representative of the bankruptcy estate, if the government prevails in showing that the refund was erroneously-issued, the Trustee's liability is entitled to administrative expense status. *See*, *e.g.*, *Reading Co. v. Brown*, 391 U.S. 471, 485 (1968) ("We hold that damages resulting from the negligence of a receiver acting within the scope of his authority as receiver give rise to 'actual and necessary costs' of a Chapter XI arrangement."); *In re Charlesbank Laundry, Inc.*, 755 F.2d 200, 201 (1st Cir. 1985) (applying *Reading* and holding that "a civil compensatory fine for violation of an injunction by a debtor corporation engaged in a Chapter 11 reorganization qualifies for first priority treatment as an administrative expense under 11 U.S.C. § 503(b)(1)(A) as 'actual, necessary costs and expenses of preserving the estate'"); *Cumberland Farms, Inc. v. Fla. Dep't of Envtl. Prot.*, 116 F.3d 16, 21 (1st Cir. 1997) (civil fine for violating state environmental laws entitled to administrative expense status). The so-called *Reading* rule, as applied in the First Circuit, provides that if a trustee's actions "considered apart from any obligation of the debtor give rise to a legal liability," then the "the claimant is entitled to the priority of a cost and expense of administration." *In re Mammoth Mart, Inc.*, 536 F.2d 950, 955 (1st Cir. 1976).

In this case, the Debtor had, pre-petition, paid $15.5 million towards its 2013 income tax liability, and then the Trustee filed, post-petition, an income tax return (Form 1120) for the corporation reporting that Debtor had no income tax liability. That return also constituted a claim for refund in the amount of $15.5 million on behalf of the bankruptcy estate. *See* 26

C.F.R. § 301.6402-3(a)(1). The IRS erroneously issued the refund and the Trustee is currently holding the $15.5 million. It is the Trustee's actions in filing a claim for refund—independent from the Debtor's effort to pay its taxes and the Trustee's effort to file the return as required by 26 U.S.C. § 6012(b)(3) on behalf of the corporation—that resulted in the erroneous refund. Thus, the Trustee created the erroneous refund and created the debt (and continues to hold the funds that could be used to resolve this dispute); accordingly, the Trustee must return the property, or alternatively, the debt created by the erroneous refund is entitled to administrative expense status. As the First Circuit recognized, the heart of the *Reading* rule is that there are "instances where fundamental fairness required that the claimant's right to distribution take precedence over the rights of general creditors." *In re Hemingway Transp., Inc.*, 993 F.2d 915, 929 (1st Cir. 1993). Here, the Trustee is holding a $15.5 million erroneous refund that belongs to the United States—it would be fundamentally unfair to allow those funds be dissipated through the payment of other creditors including other administrative expenses.[1]

2. Section 507(c) does not apply to administrative expenses.

Even if the erroneous refund were treated as property of the estate, the right to payment for the erroneous refund would be an administrative expense under § 503(b) because it is a debt incurred by the Trustee, and as an administrative expense, it is not governed by § 507(c). The Trustee contends, essentially, that the right to payment for the erroneous refund is not an

[1] The Trustee contends, in a footnote, that a "constructive trust" may only be imposed when there is fraud. *See* Opposition Memo, at p. 4 n.2. This is incorrect. "A constructive trust is a flexible tool of equity designed to prevent unjust enrichment resulting from fraud, a violation of a fiduciary duty or confidential relationship, *mistake*, or other circumstances in which a recipient's acquisition of legal title to property amounts to unjust enrichment." *Yokozeki v. Carr-Locke*, No. CV 13-12587-MBB, 2017 WL 1160569, at *4 (D. Mass. Mar. 28, 2017), *on reconsideration in part*, No. CV 13-12587-MBB, 2017 WL 2818981 (D. Mass. June 29, 2017) (citations and internal quotations omitted) (emphasis added).

"expense" under § 503(b) because § 507(c) makes it a "claim." *See* Opposition Memo, at p. 8. He points out that the "decisional law" interpreting the Bankruptcy Code is riddled with examples of courts using the terms "claim" and "expense" interchangeably. *See id.*, at p. 9. The Trustee relies on the introductory clause to § 507(c), which states "for purposes of subsection (a) of this section," in support of his argument that while § 507(c) only applies to a "claim," that term includes "expenses." *See id.*, at p. 8. This argument ignores the plain language of § 507(a), however.

Section 507(a) specifically distinguishes between "expenses" and "claims." 11 U.S.C. § 507(a) ("The following *expenses* and *claims* have priority in the following order …") (emphasis added). The term "expenses" in § 507(a) refers to "administrative expenses allowed under section 503(b) of this title." 11 U.S.C. § 507(a)(2). The other nine priority items listed in § 507(a) are all described as "claims." Thus, regardless of the usage of terms in other sections of the Bankruptcy Code, § 507 makes a distinction between claims and expenses, and when § 507(c) identifies "a *claim* … arising from an erroneous refund" it is not referring to those items that are an administrative expense under § 503(b).

Section 503 uses the term "administrative expenses," which are the expenses that are distinguished from claims in § 507(a)(2). Admittedly, other Bankruptcy Code provisions refer to administrative expenses allowed under § 507(a)(2) as "claims." *See*, *e.g.*, 11 U.S.C. §§ 726(b), 1123(a)(1), 1129(a)(9)(A), 1226(b)(1), 1326(b)(1). However, in the particular context of § 507(c), Congress referred only to a "claim," and in the very same statute, Congress distinguished between "claims" and "expenses" in § 507(a). Thus, if a right to payment for an erroneous refund is an administrative expense because it is a debt that was incurred by the Trustee, then it is not governed by § 507(c) because that subsection only applies to "claims."

This distinction between a debt for an erroneous refund incurred by a trustee post-petition and a debt incurred by the debtor prepetition is exhibited by the same distinction made with respect to "quickie refunds" given to a trustee under 11 U.S.C. §§ 541 and 505. Section 503(b)(1)(B)(ii) affords administrative expense status to "any tax … attributable to an excessive allowance of a tentative carryback adjustment that *the estate received*, whether the taxable year to which such adjustment relates ended before or after the commencement of the case." 11 U.S.C. 503(b)(1)(B)(ii) (emphasis added). The key to administrative expense status for the "quickie refund" is whether the "estate received" the refund ("excessive allowance")—not whether the refund related to a taxable year that ended prepetition or post-petition ("before or after the commencement of the case").

Contrary to the Trustee's argument, the government's right to payment for the erroneous refund is not based on a claim against the Debtor or a prepetition tax debt. The Trustee cites § 502(i) for the proposition that taxes that are due post-petition but incurred pre-petition are priority claims. *See* Opposition Memo, at p. 10. He argues that "[t]he Service's claim on account of the refund is based upon the Debtors' alleged tax liability for 2013." *Id*. However, the Trustee's analogy to § 502(i) is flawed because the debt for the erroneous refund was not incurred prepetition. In fact, the Debtor had paid the $15.5 million towards its 2013 tax liability. To be sure, the Debtor had additional unpaid taxes for 2013, but that does not change the fact that it had already paid the $15.5 million and there was no debt of the Debtor for that amount. For example, if a taxpayer's tax liability is $100 million and he pays $15.5 million prepetition, and then files for bankruptcy, its tax debt on the petition date is only $84.5 million; the taxpayer-debtor does not have a debt for the $15.5 million on the petition date because that money had already been paid. Here, the Trustee, as an alleged assignee of the Debtor's claim for refund (*see*

11 U.S.C. § 541(a)), filed the 2013 income tax return and included a claim for refund of the $15.5 million payment that the Debtor had made prepetition. And unfortunately, the IRS erroneously issued the $15.5 million refund to the Trustee. Thus, the Trustee created the $15.5 million debt post-petition.

In sum, the analysis as to whether the erroneous refund is an administrative expense or priority claim is simplified in answering two questions: (1) who incurred the debt—the Trustee in asserting the claim for refund and receiving the erroneous refund; and (2) when did that debt accrue—post-petition after the Trustee sought a refund of taxes previously paid by the Debtor. Accordingly, the request for payment of the erroneous refund is, at a minimum, an administrative expense.

3. The 2014 income tax return was due post-petition so it is an administrative expense.

In the Opposition Memo, the Trustee does not address the government's argument that the Bankruptcy Abuse Prevention Consumer Protection Act of 2005 ("BAPCPA") made it clear that income taxes for post-petition tax years are afforded administrative expense status, *see* Doc. No. 23, at pp. 16-18; accordingly, the government will not belabor this point. The Trustee merely restated his arguments from his opening brief in the Opposition Memo on this issue, i.e., he argues that the tax liability for 2014 was not incurred by the estate because all of the income was earned prepetition. For the sake of brevity, the government will not reiterate in detail all of arguments to the contrary that it raised in its opening brief, *see* Doc. No. 23, at pp. 19-21. However, the abbreviated version of the government's arguments are that: (1) under the Bankruptcy Code and the Internal Revenue Code, the federal income taxes are "incurred" and "calculated" on the last day of the tax period (i.e., December 31, 2014), which occurred post-petition; and (2) the Debtor and the bankruptcy estate are not separate taxable entities, but the

Trustee had a duty to file the 2014 income tax return on behalf of the Debtor, which obligates the Trustee to pay the tax, and means that the 2014 income tax was incurred by the estate.

4. The government applied its policy articulated in Tax Division Directive 137, but the directive does not confer any rights upon the Trustee.

Finally, it is important to note that Tax Division Directive 137 is an "internal agency policy regarding enforcement priorities and provides [third parties] with no legal rights." *United States v. Rivercliff Farms, Inc.*, 2016 WL 6662696, at *2 (D. Or. Nov. 10, 2016). The government's application of the directive is not subject to judicial review. *See, e.g.*, *U.S. v. Mitchell*, 778 F.2d 1271, 1276 (7th Cir. 1985) (Department of Justice guideline "for the exercise of prosecutorial discretion […] does not create a substantive right for the defendant which he may enforce, and is not subject to judicial review.").

Still, in this case, the government considered and applied its policy set forth in Tax Division Directive 137 and agreed to subordinate the overwhelming majority the IRS's claims. The government has agreed to subordinate the IRS's unsecured priority claim for the Debtor's unpaid federal income tax liability for 2013 in an amount exceeding $350 million as well as $52,593,821 of the IRS's administrative claim for the unpaid federal income tax liability for 2014. Indeed, the government is only attempting to collect the $15.5 million erroneous refund in regard to 2013, which is not property of the estate and should be returned to the IRS outright, and, for 2014, the estimated amount of tax based on "legitimate" sales of the Debtor's VoIP service—approximately $1,334,143 (plus penalties and interest thereon).

Conclusion

For the foregoing reasons, the government requests that the Court grant its cross-motion for partial summary judgment and deny the Trustee's motion.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on December 10, 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.

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