Docket #0067 Date Filed: 11/4/2019

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MASSACHUSETTS

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

RESPONSE BY TRUSTEE TO UNITED STATES OF AMERICA'S STATEMENT OF MATERIAL FACTS SUBMITTED IN SUPPORT OF ITS SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT

Stephen Darr as he is the Trustee of the Chapter 11 Bankruptcy Estates of the Debtors, in response to the United States of America's Statement of Material Facts Submitted in Support of its Second Motion for Partial Summary Judgment, states as follows:

The Debtors' Structure and Their Owners and Principals

1. The Debtors are TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc.

RESPONSE:

Admitted.

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2. TelexFree, Inc., was initially incorporated as Common Cents Communications in the Commonwealth of Massachusetts. (**Ex. 1**, ¶ 22.)

RESPONSE:

Admitted.

3. When Common Cents Communications was incorporated in Massachusetts, Carlos Wanzeler was its President, and James Merrill its Treasurer. (**Ex. 1**, ¶ 22.)

RESPONSE:

Admitted.

4. In February 2012, Wanzeler filed an article of amendment that changed the name of Common Cents Communications to TelexFree, Inc. Later that year, TelexFree, Inc., filed an annual report that listed Wanzeler and Merrill as its sole officers and directors. (**Ex. 1**, ¶ 23.)

RESPONSE:

Admitted.

5. In July 2012, TelexFree, LLC, was registered as a limited liability company in the State of Nevada. Wanzeler, Merrill, and Carlos Costa were listed as its officers. (**Ex. 1**, ¶ 24.) TelexFree, LLC, was formed to conduct TelexFree's operations outside of Massachusetts. (**Ex. 2**, ¶ 71.)

RESPONSE:

Admitted.

6. In December 2013, TelexFree Financial, Inc., was incorporated in the State of Florida. (**Ex. 2**, ¶ 73.)

RESPONSE:

Admitted.

7. Despite their separate legal existences, the Debtors "worked collaboratively in furtherance of the [Ponzi and pyramid scheme, described below]." (**Ex. 2**, ¶¶ 71–75.)

RESPONSE:

Admitted.

8. Wanzeler and Merrill ran TelexFree's operations in the United States. In 2012, Wanzeler, Merrill, and Costa owned 50%, 20%, and 30%, respectively, of TelexFree. From 2013 through the collapse of TelexFree in 2014, Wanzeler and Merrill each owned 50% of TelexFree and were its principals. (**Ex. 1**, ¶ 25; **Ex. 2**, ¶¶ 15, 70; **Ex. 3**, at 11 (50-20-30 ownership), 33 (50-50)); **Ex. 4**, at 6 (50-50).)

RESPONSE:

Admitted.

The TelexFree Ponzi and Pyramid Scheme

9. Between early 2012 and March 2014, TelexFree "operated a Ponzi and pyramid scheme." (Proceeding Memo./Order of Ct., Doc. 654, *In re TelexFree, LLC*, Case No. 14-40987 (Bankr. D. Mass. Nov. 25, 2015); **Ex. 1**, ¶ 10.)

RESPONSE:

Admitted.

10. During that period, TelexFree "purported to be in the business of selling a voice over internet service or 'VoIP' that cost $49.90 per month to conduct international phone calls." (**Ex. 2**, ¶ 21; **Ex. 1**, ¶¶ 4, 6.)

RESPONSE:

Admitted.

11. Despite calling itself a VoIP service provider, however, TelexFree derived only

1% of its "hundreds of millions of dollars in revenue" from selling its VoIP service. (**Ex. 1**, ¶ 11.)

RESPONSE:

Admitted.

12. The remaining 99% of TelexFree's revenue derived from "people buying into" the Ponzi and pyramid scheme. (**Ex. 1**, ¶¶ 11, 29.c.)

RESPONSE:

Admitted.

13. At a high level, TelexFree's Ponzi and pyramid scheme worked as follows:

> . . . TelexFree purported to aggressively market its [VoIP] service by recruiting thousands of "promoters" [referred to as the Participants by the Trustee] to post ads for the product on the Internet. Each promoter was required to 'buy in' to TelexFree at a certain price, after which they were compensated by TelexFree, under a complex compensation structure, on a weekly basis so long as they posted ads for TelexFree's [VoIP] service on the Internet. What TelexFree failed to disclose, however, was that the [VoIP] service was a front, and that the ad-posting requirements were a meaningless exercise, in which promoters cut and paste ads into various classified ad sites provided by TelexFree and already saturated with ads posted by other promoters.

(**Ex. 1**, ¶ 10.)

RESPONSE:

The Trustee admits so much of paragraph 13 that states Telexfree operated a Ponzi and pyramid scheme, but the Trustee denies the description of the Telexfree business as characterized in the balance of paragraph 13. *See Trustee Statement of Undisputed Facts in Support of his Opposition by Chapter 11 Trustee to United States of America's Second Motion for Partial Summary Judgment* ("Trustee Statement of Undisputed Facts"), ¶1-12 as a more thorough and accurate description of Telexfree business.

14. Participants had two ways to buy into the TelexFree Ponzi and pyramid scheme

and potentially receive money for the "meaningless exercise" of copying and pasting ads online. First, a Participant could pay TelexFree $339 and agree to post one ad per day for a year. If the Participant posted an ad each day, then each week the Participant was entitled to a VoIP package, which could be sold or exchanged for $20 in credits within the Ponzi and pyramid scheme. Through this plan, if a Participant posted an ad each day and redeemed the resulting credits for cash, the Participant could be eligible for $20 per week, or up to $1,040 for the year, a return of 207%. Second, a Participant could pay TelexFree $1,425 and agree to post five ads per day for a year. After placing five ads daily for a week, the Participant was entitled to five VoIP packages, which could be sold or exchanged for $100 in credits. Through this plan, if a Participant posted five ads each day and redeemed the resulting credits for cash, a Participant could be eligible for $100 per week, or up to $5,200 for the year, a return of 265%. (**Ex. 2**, ¶¶ 23, 26; **Ex. 1**, ¶¶ 10, 42–45.)

RESPONSE:

The Trustee admits paragraph 14 except with respect to the reference as the "meaningless exercise". The Trustee acknowledges using that phrase when describing the value to be ascribed to the credits post-petition in connection with determining claims. However, in the context of the operation of Telexfree's business of selling membership plans, the posting of ads and earning credits was material and essential to the growth of the business. See, deposition of Trustee, **Exhibit 1**, to *Affidavit of Charles R. Bennett, Jr.*, pg. 37-41 and 66-67, and deposition of Thomas Greenaway, **Exhibit 2,** to *Affidavit of Charles R. Bennett, Jr.*, pg. 52, 53, 57.

15. The "credits" that Participants could earn for copying and pasting [sp.] ads online "could be redeemed for cash, transferred to another User Account, or applied in satisfaction of an invoice for another User Account." Credits were applied in satisfaction of an invoice for another

User Account when a Participant recruited a new Participant, the new Participant paid the recruiter the buy-in amount in cash, and the recruiter then used his or her own pre-existing credits to satisfy the invoice owed by the new Participant to TelexFree. (**Ex. 2**, ¶¶ 26, 29.)

RESPONSE:

Admitted.

16. TelexFree did not limit the number of times that Participants could buy into its Ponzi and pyramid scheme, which allowed Participants to buy in multiple times and thereby multiply the returns promised to them by TelexFree. (**Ex. 1**, ¶ 38.)

RESPONSE:

Admitted.

17. Participants' promised "earnings" from the TelexFree Ponzi and pyramid scheme were not dependent on their "advertisements" resulting in any sales of TelexFree's VoIP services. TelexFree was only able to pay Participants "by bringing in money from newly-recruited promoters." (**Ex. 1**, ¶ 11.)

RESPONSE:

The Trustee admits so much of paragraph 17 that states that there was no direct earnings connection between the amount of credit issued by Telexfree to a Participant and the sale of membership or VOIP plans that resulted from the ads posted by that Participant. However, the amount of credits that could be earned by a Participant for posting ads had a causal connection to recruiting more people to join Telexfree. The Trustee further states that there was a causal connection between the amount of credits that a Participant could earn by posting ads and recruiting others and the growth of TelexFree's business.

18. On TelexFree, LLC's Form 1120X, Amended U.S. Corporation Income Tax

Return, for the year 2012, and its Forms 1120, U.S. Corporation Income Tax Returns, for the years 2013 and 2014, described in more detail below at paragraphs 35–36, 44, and 55, the Trustee reported TelexFree's promises to pay Participants for their "advertisements" as "ADVERTISING CREDIT EXPENSE" or "ADVERTISING CREDITS EXPENSE." (**Ex. 3**, at 13, 15, 46; **Ex. 4**, at 16.)

RESPONSE:

The Trustee admits so much of paragraph 18 that states certain of the returns contain the words Advertising Credit Expense and Advertising Credits Expense. The Trustee further states that on or about March 7, 2018, the Trustee filed amended tax returns for 2012, 2013, and 2014.

19. Participants in the TelexFree Ponzi and pyramid scheme also could earn money by recruiting other Participants. For recruiting a new Participant who invested $350, a Participant would earn $20 in credits; for recruiting a new Participant who invested $1,425, the Participant would earn $100 in credits. As in any pyramid or multi-level marketing scheme, a Participant would earn more money if the people that he or she recruited into the scheme in turn recruited more people. (**Ex. 1**, ¶ 47; **Ex. 2**, ¶ 24.a.)

RESPONSE:

Admitted.

20. On TelexFree, LLC's Form 1120X for the year 2012, and its Form 1120 for the year 2013, described in more detail below at paragraphs 35–36 and 44, the Trustee reported TelexFree's promises to pay Participants for recruiting new scheme victims as "AGENT COMISSION [sic]" or "COMMISIONS [sic]." No similar line item was included on the Form 1120 for the year 2014. (**Ex. 3**, at 15, 46; **Ex. 4**, at 16.)

RESPONSE:

Admitted. The Trustee further states that the term "Advertising Credits Expense" on the Form 1120 for 2014 included expense for both advertising and commission expense. (The identical deduction amount appears on Form 1120X for 2014 under the heading "Gross Credit Liability Accrual".

21. Between February 2012 and April 2014, TelexFree had $359,792,242 in cash receipts. (**Ex. 2**, at 21.)

RESPONSE:

Admitted.

The Brazilian Piece of the TelexFree Ponzi and Pyramid Scheme

22. In 2010, Wanzeler registered Ympactus as a corporate entity in Brazil. (**Ex. 1**, ¶ 17.)

RESPONSE:

Admitted.

23. Ympactus was owned by Wanzeler, Merrill, and Costa. (**Ex. 1**, ¶ 17.)

RESPONSE:

Admitted.

24. Ympactus was the Brazilian version of the TelexFree Ponzi and pyramid scheme, and started operating in Brazil in early 2012, at about the same time TelexFree began operating in the United States. Ympactus had the same structure and sales terminology as TelexFree. Ympactus shared TelexFree's website and its database for Participants, and used the "TelexFree" brand name in Brazil. (**Ex. 1**, **¶¶** 17, 27; **Ex. 2**, **¶¶** 50, 53.)

RESPONSE:

Admitted.

25. During 2012 and 2013, TelexFree contends that it "recognized income totaling $186,053,089 in the form of a net receivable" from Ympactus. (Compl., Doc. 1, ¶ 26.) TelexFree does not allege in the complaint that it reported that net receivable as income on any tax return. (*Id.* ¶¶ 26–28; Answer, Doc. 4, ¶¶ 26–28.)

RESPONSE:

The Trustee admits Paragraph 25. The Trustee states the amount of the Ympactus receivable is reported on the 2012 and the2013 Tax Returns of Telexfree filed by the Trustee.

26. In mid-2013, Brazilian authorities filed claims against Ympactus, Wanzeler, Wanzeler's wife, and Merrill; suspended Ympactus's operations and commenced a civil enforcement action against it; and seized nearly $300,000,000 from Ympactus. The civil enforcement action resulted in "an injunction prohibiting TelexFree from recruiting new promoters and from taking in funds or paying money to existing TelexFree promoters." A Brazilian court has determined that Ympactus was a pyramid scheme. (**Ex. 1**, ¶ 18; **Ex. 2**, ¶ 51.)

RESPONSE:

Admitted.

27. Between February 2012 and June 2013, Ympactus had $1,308,049,021 in cash receipts. (**Ex. 2**, at 21 (Ex. 1 to Darr Affidavit).)

RESPONSE:

Admitted.

The TelexFree Ponzi and Pyramid Scheme Collapses

28. In 2013, the Massachusetts Securities Division began investigating TelexFree, which contributed to TelexFree announcing changes to its compensation system in early March 2014: Participants would have to actually sell TelexFree's VoIP services to earn compensation.

In response to the change, Participants began protesting at its headquarters. (**Ex. 1**, ¶ 12.)

RESPONSE:

Admitted.

29. On Sunday, April 13, 2014, the Debtors each filed a voluntary Chapter 11 petition with the United States Bankruptcy Court for the District of Nevada, which ordered that the cases be jointly administered. (Ch. 11 Voluntary Pet'n, Doc. 1, *In re TelexFree, LLC*, Case No. 14-40987 (Bankr. D. Mass.); Ch. 11 Voluntary Pet'n, Doc. 1, *In re TelexFree, Inc.*, Case No. 14-40988 (Bankr. D. Mass.); Ch. 11 Voluntary Pet'n, Doc. 1, *In re TelexFree Fin'l, Inc.*, Case No. 14-40989 (Bankr D. Mass.); Order Granting Joint Administration, Doc. 77, *In re TelexFree, LLC*, Case No. 14-40987 (Bankr D. Mass.).) The proceedings were transferred to this Court, and a Chapter 11 trustee, Stephen Darr, was appointed. (Order on Mtn. to Transfer Case/Change Venue, Doc. 203, *In re TelexFree, LLC*, Case No. 14-40987 (Bankr D. Mass.); Order on Mtn. to Appoint Ch. 11 Trustee, Doc. 234, *In re TelexFree, LLC*, Case No. 14-40987 (Bankr D. Mass.).)

RESPONSE:

Admitted.

30. On April 15, 2014, federal agents executed search warrants at TelexFree's headquarters and "intercepted TelexFree's acting Chief Financial Officer ('CFO') trying to leave the premises with a laptop and a bag." The bag contained "ten Wells Fargo Bank cashiers' checks totaling $37,948,296. Eight of the checks were dated April 11, 2014 (the Friday before the . . . bankruptcy filing) and were remitted to Merrill." Five of those checks "were made out to TelexFree, LLC, in the total amount of $25,548,809, while one check was made out to Wanzeler's wife, in the amount of $2,000,635." Another check, "remitted to Wanzeler himself, was made out to TelexFree Dominicana SRL, in the amount of $10,398,000." Merrill and

Wanzeler's wife had traveled to Rhode Island to pick up nine of the checks on or about April 11, 2014. (**Ex. 1**, ¶ 15).

RESPONSE:

Admitted.

31. Wanzeler fled the United States and is believed to be in Brazil. There is a warrant out for his arrest. (**Ex. 2**, ¶ 15; "United States v. Carlos Wanzeler and James Matthew Merrill," U.S. Attorney's Office, District of Mass. ("Defendant Carlos Wanzeler"), *available at* https://www.justice.gov/usao-ma/victim-and-witness-assistance-program/united-states-v-carlos-wanzeler-and-james-matthew-merrill.)

RESPONSE:

Admitted.

32. Merrill was arrested and ultimately pleaded guilty to one count of wire fraud conspiracy and eight counts of wire fraud. As part of his plea agreement, Merrill forfeited approximately $140 million, as well as other assets. In 2017, Merrill was sentenced to six years in prison and three years of supervised release. He remains incarcerated with a release date in 2022. (Plea Agreement, Doc. 314, at 1, *United States v. Merrill*, Case No. 14-40028 (D. Mass.); Electronic Clerk's Notes For Sentencing Proceeding, Doc. 346, *id.*; Preliminary Order of Forfeiture, Doc. 347, *id.*; "Former President of Telexfree Sentenced for Billion Dollar Pyramid Scheme," Dep't of Justice, U.S. Attorney's Officer, District of Mass. (Mar. 22, 2017), *available at* https://www.justice.gov/usao-ma/pr/former-president-telexfree-sentenced-billion-dollar-pyramid-scheme (stating that forfeiture included "approximately $140 million and other assets"); "Find an inmate," Bureau of Prisons, available at https://www.bop.gov/mobile/find_inmate/byname.jsp#inmate_results (search for James M Merrill).)

RESPONSE:

The Trustee admits so much of the statement of paragraph 32 that states Merrill was arrested, pled guilty and that part of his plea agreement was that he forfeited any interest he may have had in the property seized by the United States government. The Trustee disputes that the property seized was the property of Merrill. The Trustee asserts the property seized was Telexfree property. See Trustee Statement of Undisputed Facts at ¶ 90-96.

33. In 2017, a Brazilian national pleaded guilty to conspiracy to money laundering, for his intention to launder approximately $20 million from the TelexFree scheme—which federal authorities found in a mattress box spring—to Wanzeler in Brazil. (*See* "Brazilian National Pleads Guilty to Scheme to Launder $20 Million in Proceeds from the TelexFree Fraud," Dep't of Justice, U.S. Attorney's Office, District of Mass. (Oct. 19, 2017), *available at* https://www.justice.gov/usao-ma/pr/brazilian-national-pleads-guilty-scheme-launder-20-million-proceeds-telexfree-fraud.)

RESPONSE:

Admitted. The Trustee states the money seized was property of Telexfree. See Trustee Statement of Undisputed Facts at ¶ 90-96.

TelexFree, LLC's Tax Returns, the IRS Audit, and the IRS's Claims

A. Tax Year 2012

34. In September 2013, TelexFree, LLC, filed a Form 1120, U.S. Corporation Income Tax Return, for the tax period ending December 31, 2012. On the return, TelexFree reported total income of $2,080,067, claimed deductions totaling $62,065, and reported tax due of $686,121 and an estimated tax penalty due of $6,733, for a total amount owed of $692,854. Based on that return, on September 30, 2013, the Internal Revenue Service assessed TelexFree, LLC, income taxes of $686,121, and penalties and interest totaling $198,984.24. Through a

payment of $706,713.79 on October 16, 2013, and a payment of $179,986.86 on December 12, 2013, TelexFree, LLC, fully paid its income tax liability for 2012. (**Ex. 3**, at 19; **Ex. 12**, at 1–2.)

RESPONSE:

The Trustee admits the statement contained in paragraph 34. The Trustee states that he subsequently filed an amended tax return for the tax year ending 2012, which asserted a net loss carry back for 2012 tax year and an entitlement to a refund for tax year ending December 31, 2012 in the amount of $886,700. *See Affidavit of Thomas Greenaway* ("Greenaway Affidavit").

35. On or about September 9, 2016, the Trustee sent the IRS two tax returns for TelexFree, LLC, dated that same day that each requested a refund: a Form 1120X, Amended U.S. Corporation Income Tax Return, for the tax period ending December 31, 2012 (attached to which was a copy of the original Form 1120 for that period), and a Form 1120, U.S. Corporation Income Tax Return for the tax period ending December 31, 2013. (*See* **Ex. 3**, at 1.)

RESPONSE:

The Trustee admits the statement in paragraph 35 and further states that each return was subsequently amended. *See* Greenaway Affidavit.

36. Through the Form 1120X for 2012, the Trustee sought a refund of $692,854 in taxes previously paid toward TelexFree's 2012 income taxes. The Trustee reported that TelexFree, LLC, had $15,407,680 in total income, and claimed deductions totaling $16,647,623, for taxable income of ($1,239,943). The claimed deductions included $1,175,236 for "AGENT COMISSION [sic]" and $9,829,080 for "ADVERTISING CREDIT EXPENSE." (**Ex. 3**, at 3, 6, 15.)

RESPONSE:

Admitted, but the Trustee subsequently filed an Amended Return for 2012. See

Greenaway Affidavit.

37. The IRS disallowed the claim for refund contained on the Form 1120X for 2012. (**Ex. 6**, at 4.)

RESPONSE:

The Trustee admits the IRS disallowed the claimed refund, however by so admitting, the Trustee is not admitting the disallowance was valid.

38. On or about March 7, 2018, the Trustee submitted a second Form 1120X, dated March 7, 2018, to the IRS, again seeking a refund of $692,854. On the second Form 1120X, the Trustee reported that TelexFree, LLC, had $18,220,915 in gross receipts or sales and $17,866,860 in total income, claimed deductions totaling $4,430,999, and claimed a net operating loss deduction of $13,435,861, which led the Trustee to report $0 in taxable income and tax due. The second Form 1120X no longer claimed the commissions and advertising credit expenses as deductions. The second Form 1120X contained a new deduction for "GROSS CREDIT LIABILITY ACCRUAL" of $4,261,846. The Trustee explained that the gross credit liability accrual deduction represented "[t]he credits deposited in Ponzi scheme users' accounts during 2012," which reflected $3,407,954 redeemed by users to satisfy invoices and $853,892 redeemed by users for cash. (**Ex. 5**, at 1, 5, 14, 15; **Ex. 7**, at 3 (Response to Interrogatory No. 2).)

RESPONSE:

The Trustee admits the statements in paragraph 38, except the Trustee disputes the Service's characterization that the "second Form 1120X contain new deduction". The Trustee states "Gross Credit Liability Accrual" refers to the same deduction as previously identified to as "Advertising Credits or Agent Comissions or Commissions." See Trustee Statement of Fact,

paragraph ¶ 31.

39. Of TelexFree's reported $18,220,915 in gross receipts, "$2,943,517 was received by TelexFree in cash"; "$3,407,954 was based upon credits redeemed by participants"; "$87,525 was earned through the sale by TelexFree of VoIP service"; and "$6,152,768 was earned by the sale by TelexFree of membership plans to participants." (**Ex. 7**, at 3 (Response to Interrogatory No. 1).)

RESPONSE:

Admitted.

40. The IRS disallowed the claim for refund contained on the second Form 1120X for 2012, based on its disallowance of the gross credit liability accrual expense and the net operating loss. (*See* **Ex. 6**, at 1, 4.).

RESPONSE:

The Trustee admits the Service disallowed the claimed refunds. However, by admitting the Service's action, the Trustee is not admitting the disallowance is valid.

41. The IRS has not filed a proof of claim or a request for payment of administrative expenses for the year 2012.

RESPONSE:

Admitted.

B. Tax Year 2013

42. On or about March 17, 2014, TelexFree, LLC, attempted to pay the IRS $15,792,982 toward its 2013 income taxes. The payment was dishonored and the IRS assessed a dishonored payment penalty of $315,859.64. (**Ex. 13**, at 1–2; Doc. 22-1, Bankruptcy Specialist Declaration, ¶ 11.)

RESPONSE:

Admitted. The Trustee further states that he has requested an abatement of the penalty, which the Service has not yet ruled upon.

43. On or about March 31, 2014, TelexFree, LLC, paid the IRS $15,792,982 toward its 2013 income taxes. (**Ex. 13,** at 2.)

RESPONSE:

Admitted.

44. Through the Form 1120 for 2013 that the Trustee submitted to the IRS on or about September 9, 2016, the Trustee sought a refund of $15,858,111 in taxes previously paid toward TelexFree's 2013 income taxes. The Trustee reported that TelexFree, LLC, had $861,540,102 in total income, and claimed deductions totaling $2,963,526,039, for taxable income of ($2,101,985,935). The claimed deductions included $186,344,898 for bad debts, $622,588,034 for "COMMISIONS [sic]," and $2,151,645,140 for "ADVERTISING CREDITS EXPENSE." (**Ex. 3**, at 28, 46.)

RESPONSE:

Admitted.

45. The Form 1120 for 2013 dated September 9, 2016, was selected for examination. Despite a bankruptcy/litigation hold code in place on TelexFree, LLC's 2013 account in the IRS's internal computer system that should have prevented the issuance of a refund for that year, a computer-generated refund in the amount of $15,532,440.39 was sent to the Trustee for the 2013 tax year, and interest in the amount of $55,318.03 was credited to the account. The sum of the computer-generated refund and the interest credited to the account represented the $15,792,982 TelexFree paid toward its 2013 income taxes, minus the dishonored payment

penalty of $315,859.64. (Doc. 22-1, Bankruptcy Specialist Declaration, ¶¶ 7–11; Doc. 22-2, Revenue Agent Declaration, ¶¶ 6–9; **Ex. 13**, at 1–2.)

RESPONSE:

The Trustee admits that the statement contained in Paragraph 45 is a summary of the Service's Bankruptcy Specialist testimony. The Trustee has no knowledge of what actually occurred and why or if the Service's internal computer system malfunctioned.

46. The IRS filed a request for payment as an administrative expenses under 11 U.S.C. § 503 against TelexFree, LLC, for corporate income tax for the year 2013 in the amount of $15,532,440.39, and filed a counterclaim in this adversary proceeding for the recovery of the erroneous refund. The administrative expense for 2013 arose from the IRS's erroneous refund to the Trustee. (Claim No. 2987-2, *In re TelexFree, LLC*, Case No. 14-40987; Doc. 22-1, Bankruptcy Specialist Declaration, ¶¶ 7–11; Answer, Doc. 4, ¶¶ 74–84.)

RESPONSE:

The Trustee admits the statements in paragraph 46, except for the reasons set forth in the Trustee's Motion for Partial Summary Judgment and the Opposition by Chapter 11 Trustee to United States of America's Second Motion for Partial Summary Judgment ("Opposition"), the Trustee asserts the refund was due the Trustee and the payment to the Trustee was valid and, further, if the Service has any claim pertaining to 2013, such claim constitutes a prepetition unsecured claim. *See* Trustee's Motion for Partial Summary Judgment, doc. no. 12; Opposition by Trustee to Cross-Motion of Internal Revenue Service for Partial Summary Judgement, doc. no. 27; and Opposition filed herewith.

47. At the conclusion of its audit of the Form 1120 for 2013, on October 31, 2017, the IRS issued a Letter 531, Notice of Deficiency, to TelexFree, LLC, with copies to the Trustee and

the Trustee's counsel, in which the IRS notified TelexFree, LLC, that it had determined that TelexFree owed an additional $300,507,248 in income tax for the year 2013, as well as a penalty of $75,126,857 pursuant to 26 U.S.C. § 6651(a)(1). (**Ex. 8**, at 1, 8, 10–12.)

RESPONSE:

Trustee admits the IRS took the actions described in paragraph 47, but the Trustee denies that the actions by the Service in disallowing the deductions and assessing a tax and a penalty were valid. See Opposition filed herewith.

48. The IRS's Notice of Deficiency was based on its disallowance of three deductions claimed on TelexFree, LLC's income tax return for 2013: the bad debt deduction of $186,344,898; the deduction for "Commissions" of $622,588,034; and the deduction for "Advertising Credits" of $2,151,645,140. As a result of this $2,960,578,072 adjustment to TelexFree's reported income, TelexFree's revised taxable income was $858,592,137 and its corrected tax liability based on that revised taxable income was $300,507,248. (**Ex. 8**, at 10 (Statement – Income Tax Changes).)

RESPONSE:

Trustee admits the actions described in paragraph 48, but the Trustee denies that the actions by the Service were valid in disallowing the deductions, assessing a tax and a penalty. See Opposition filed herewith.

49. The IRS filed a proof of claim under 11 U.S.C. § 502 for an unsecured priority claim against TelexFree, LLC, for corporate income tax for the year 2013 in the amount of $285,710,294.86, representing tax of $285,030,125.64 and interest to the petition date of $680,169.22. The proof of claim also included an unsecured general claim of $71,188,566.50 for penalties to the petition date. (Claim No. 2988-1, *In re TelexFree, LLC*, Case No. 14-40987.)

These amounts did not include the erroneous-refund portion of the claim asserted as an administrative expense.

RESPONSE:

Trustee admits the IRS filed a proof of claim as described in paragraph 49, but the Trustee denies that the amount claimed by the Service is due and owing. *See* Opposition filed herewith.

50. On or about March 7, 2018, the Trustee filed a Form 1120X, Amended U.S. Corporation Income Tax Return, for TelexFree, LLC, for the tax year ending December 31, 2013. On the Form 1120X, the Trustee increased TelexFree's reported total income to $1,167,954,153 based on gross receipts or sales of $1,173,886,556; decreased the claimed deductions to $1,171,098,004; and reported taxable income of ($3,143,851). The Form 1120X for 2013 contained the same bad debt expense as described in paragraphs 44 and 48, above, but no longer claimed the commissions and advertising credit expenses. In lieu of the commissions and advertising credit expenses, the Trustee claimed a deduction of $972,955,648 for "GROSS CREDIT LIABILITY ACCRUAL." (**Ex. 9**, at 1, 4, 17.)

RESPONSE:

The Trustee admits the statements in paragraph 50, except the Trustee denies any implication that "Gross Credit Liability Accrual" was in "lieu of the commissions and advertising credit" and states the Gross Credit Liability Accrual included both commissions and advertising credits.

51. Of the $1,173,886,556 in gross receipts or sales reported on the Form 1120X for 2013, "$156,227,156 was received by TelexFree in cash"; "$843,475,755 was based upon credits redeemed by participants"; "$65,633,371 was earned through the sale by TelexFree of VoIP

service"; and "$934,252,624 was earned by the sale by TelexFree of membership plans to participants." (**Ex. 7**, at 4 (Response to Interrogatory No. 3).)

RESPONSE:

Admitted.

52. Of the $972,955,648 for gross credit liability accrual, $68,144,795 represented credits redeemed for cash, $843,475,755 represented credits redeemed to satisfy invoices, and $61,335,098 represented credits outstanding at the end of the year. (**Ex. 7**, at 4–5 (Response to Interrogatory No. 4); **Ex. 9**, at 18.)

RESPONSE:

The Trustee admits the amounts specified in paragraph 52 are accurate, but denies there is any causal relationship between the gross credit liability and the credits redeemed.

53. The IRS did not accept the Form 1120X for the year 2013 for processing, and did not make any changes to its proof of claim or its request for payment of administrative expenses for the year 2013 based on it.

RESPONSE:

The Trustee has no knowledge as to the processing activities of the Service but admits that the Service did not amend its proofs of claim.

C. Tax Year 2014

54. TelexFree, LLC, never made any payments toward its 2014 income taxes. (**Ex. 14**, at 1–2.)

RESPONSE:

The Trustee admits that he did not make any payment, but denies owing any tax for that tax year.

55. On or about June 20, 2017, the Trustee sent the IRS a Form 1120, U.S. Corporation Income Tax Return, for TelexFree, LLC, for the tax year 2014. Through the Form 1120 for 2014, the Trustee reported that TelexFree, LLC, had $161,550,353 in total income, and claimed deductions totaling $2,450,176,063, for taxable income of ($2,288,625,710). The claimed deductions included an "ADVERTISING CREDITS EXPENSE" of $2,442,705,606. (**Ex. 4**, at 1, 16.)

RESPONSE:

The Trustee admits the statement in paragraph 55. The Trustee states that the reference to Advertising Credits Expense including both advertising expense and commissions. The Trustee states he filed an Amended 2014 return on March 7, 2018. *See* Greenaway Affidavit.

56. On November 7, 2017, the IRS issued Notices of Proposed Adjustment proposing the following adjustments to the Form 1120 for the year 2014: the disallowance of the $2,442,705,606 deduction for advertising credits expense; the disallowance of the $2,578,363,363 net operating loss; and, the assessment of a failure-to-file penalty. With the disallowance of the advertising credits expense, the IRS calculated TelexFree's corrected income tax liability for 2014 as $53,927,964, and its failure-to-file penalty as $13,481,991. (**Ex. 10**, at 1–2, 11–14.) The IRS is in the process of issuing a notice of deficiency based on these adjustments.

RESPONSE:

The Trustee admits that the Service issued the Notice of Proposed Adjustment, but denies that the proposed adjustment was valid. *See* Opposition filed herewith. The Trustee also disputes any administrative priority for taxes that may be owed for 2014. *See* Trustee's Motion for Partial Summary Judgment, doc. no. 12; Opposition by Trustee to Cross-Motion of Internal Revenue Service for Partial Summary Judgement, doc. no. 27.

57. On November 30, 2017, the IRS filed a request for payment of an administrative expense against TelexFree, LLC, for corporate income tax for the year 2014 in the amount of $53,927,964. (Claim No. 2987-2, *In re TelexFree, LLC*, Case No. 14-40987.)

RESPONSE:

The Trustee admits the Service filed a request for payment of administrative expense, but the Trustee denies the Service is entitled to an administrative expense claim. *See* Trustee's Motion for Summary Judgment, doc. no. 12; and Opposition by Trustee to Cross-Motion of Internal Revenue Service for Partial Summary Judgement, doc. no. 27; Opposition, filed herewith .

58. On or about March 7, 2018, the Trustee filed a Form 1120X, Amended U.S. Corporation Income Tax Return, for TelexFree, LLC, for the tax year ending December 31, 2014. On the Form 1120X, the Trustee increased TelexFree's reported total income to $2,065,852,478 based on gross receipts or sales of $2,067,416,945; increased the claimed deductions to $2,601,446,626; and reported taxable income of ($535,594,148). The Form 1120X for 2014 no longer claimed the advertising credit expense described above at paragraph 55. The Trustee claimed a deduction of $148,000,000 for "165 LOSS SEC ASSET SEIZURE" and a deduction of $2,442,705,607 for "GROSS CREDIT LIABILITY ACCRUAL." (**Ex. 11**, at 1, 3,

6, 17.)

RESPONSE:

The Trustee admits the statement contained in Paragraph 58, except the Trustee states that in the amended return for 2014, the advertising credit expenses were included as part of the Gross Credit Liability Accrual.

59. Of the $2,067,416,945 in gross receipts or sales reported on the Form 1120X for 2014, "$200,621,569 was received by TelexFree in cash"; "$1,866,795,376 was based upon credits redeemed by participants"; "$404,504,071 was earned through the sale by TelexFree of VoIP service"; and "$1,662,962,874 was earned by the sale by TelexFree of membership plans to participants." (**Ex. 7**, at 5 (Response to Interrogatory No. 5).)

RESPONSE:

Admitted.

60. Of the $2,442,705,607 for gross credit liability accrual, $83,212,109 represented credits redeemed for cash, $1,866,795,376 represented credits redeemed to satisfy invoices, and $554,033,219 represented credits outstanding at the end of the year. (**Ex. 7**, at 6 (Response to Interrogatory No. 6); **Ex. 11**, at 18.)

RESPONSE:

The Trustee admits the amounts are accurate, but denies that the amounts are related.

61. The $148,000,000 deduction pursuant to 26 U.S.C. § 165 represented a claimed "casualty loss . . . based upon information provided by the United States, including statements made in the Sentencing Memorandum filed on March 16, 2017 [document number 332] in criminal action 14-CR-40028-TSH, United States District Court for the District of Massachusetts," *i.e.*, primarily for Merrill's forfeiture of assets totaling approximately

$140,000,000 as part of his criminal sentence, as described above at paragraph 32. On or about June 18, 2019, the Trustee received $145,471,294 from the United States Treasury. (**Ex. 7**, at 6–7 (Response to Interrogatory No. 7.)

RESPONSE:

The Trustee denies the statements in paragraph 61. The Trustee states that while Merrill forfeited his interest in the property seized, the property was the property of Telexfree and is to be used as restitution to the victims of the Telexfree Ponzi/pyramid scheme. *See* Criminal Action 14-CR-40028-TSH, Restitution Order, docket no. 367.

62. The IRS did not accept the Form 1120X for the year 2014 for processing, and did not make any changes to its request for payment of administrative expenses for the year 2014 based on it.

RESPONSE:

The Trustee has no knowledge as to the processing activities of the Service but admits that the Service did not amend its proof of claim.

This Adversary Proceeding

63. On July 30, 2018, the Trustee filed the Complaint in this Adversary Proceeding. Through this proceeding, the Trustee seeks declaratory judgments that: (1) the "TelexFree Credits [and the Ympactus bad debt] as claimed on the TelexFree, LLC Amended Tax Returns for the tax years 2012, 2013, and 2014 are ordinary and necessary expenses of the operation of TelexFree and are deductible, pursuant to 26 U.S.C § 162"; (2) TelexFree had no taxable income for the years 2012, 2013, and 2014, is entitled to a refund of $886,700 for 2012 (reflecting $692,854 in taxes paid and "interest and penalties of $193,847"), and is entitled to keep the erroneous refund for 2013; (3) disallow the IRS's proofs of claims; (4) if TelexFree, LLC, has

income tax liability for 2013, any claim from the erroneous refund is entitled to prepetition priority unsecured claim status pursuant to 11 U.S.C § 507(a)(8); and, (5) if TelexFree, LLC, has any income tax liability for 2014, any liability is entitled to prepetition unsecured claim status pursuant to 11 U.S.C § 507(a)(8). (Complaint, Doc. 1, at ¶ 32, and pp.17–18 (prayer for relief).)

RESPONSE:

Admitted.

64. On September 4, 2018, the United States answered the Complaint and asserted a Counterclaim against the Trustee seeking a judgment in the amount of $15,532,440.39 for the erroneous refund issued to the Trustee for TelexFree, LLC's federal income taxes for 2013. (Answer and Counterclaim, Doc. 4, at ¶¶ 74–84, D.)

RESPONSE:

Admitted.

65. The Trustee and the United States have filed cross-motions for partial summary judgment related to Counts IV and V of the Complaint, which relate to the priority to be accorded to the IRS's proofs of claim and requests for payment of administrative expenses. (Docs. 12, 21.)

RESPONSE:

Admitted.

STEVEN DARR, AS HE IS THE CHAPTER 11 TRUSTEE OF THE DEBTORS' ESTATES

By his attorneys,

/s/ Andrew G. Lizotte

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Dated: November 4, 2019

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