Docket #0077 Date Filed: 11/25/2019

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,	)	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 OF AMERICA'S REPLY BRIEF IN SUPPORT OF ITS SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT

Throughout his opposition to the United States' Second Motion for Partial Summary Judgment, the Trustee appears to misconstrue the nature of this adversary proceeding and the questions posed to the Court through this motion. As explained in its Brief Statement of Issues Presented (Doc. 55-1, at 1–2), the motion asks the Court to decide Counts I, II, and III of the Complaint, and the Counterclaim, which relate to the merits of the Trustee's claim for refund for 2012 and the IRS's proofs of claims and requests for payment of administrative expenses for 2013 and 2014. These claims all turn on whether the Trustee has established that TelexFree is entitled to two (or three) categories of deductions claimed on filed returns. The Trustee asks this Court to engage in an Administrative Procedures Act-style review of the IRS's decisions to

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disallow each category of deduction—but that request is based on a faulty premise regarding the burden of proof. The Court's actual responsibility is to decide *de novo* whether the Trustee has established TelexFree's entitlement to each deduction based on the evidence of record and the applicable law. When that question is addressed, the answer is clear: as a matter of law, the Trustee has not established TelexFree's entitlement to the deductions he seeks, and the Court should grant summary judgment in favor of the United States.

I. The Trustee bears the burden of proof to establish TelexFree's entitlement to the deductions claimed on its returns.

Although the Trustee argues that two exceptions (one statutory and one judicial) to the ordinary burden of proof regarding deductions in tax cases apply (Doc. 65, at 4–6), neither exception applies. The Trustee must prove TelexFree's entitlement to the deductions.

A. The statutory exception to the ordinary burden of proof does not apply.

A narrow statutory exception to the ordinary burden of proof in tax cases exists in 26 U.S.C. § 7491(a) in order "to remove the disadvantage individuals and small business taxpayers face when forced to litigate with the IRS where those taxpayers have kept and provided the Internal Revenue Service with all information relevant to the determination of their tax liabilities." *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 169–70 (D. Conn. 2004). The Trustee cannot show that he meets the requirements of § 7491(a) and thus cannot use the statutory exception to shift the burden of proof.

Section 7491(a) creates a limited exception to the ordinary burden of proof with respect to discrete factual issues. It provides: "[i]f, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax . . ., the Secretary shall have the burden of proof with respect to such issue." 26 U.S.C. § 7491(a)(1). "Credible evidence" within the meaning of § 7491(a) is "evidence

which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)." *In re Receivership Estate of Indian Motorcycle Mfg., Inc.*, 299 B.R. 8, 25 (D. Mass. 2003) (quoting *Griffin v. Comm'r*, 315 F.3d 1017, 1021 (8th Cir. 2003)). By its own terms, § 7491(a)'s burden-shifting occurs on an issue-by-issue basis and only with respect to factual issues. *See In re Shaw*, 2013 WL 625110, at *4 (Bankr. D. Mass. Feb. 20, 2013). Section 7491(a) does not shift the ultimate burden of proof with respect to deductions, which always rests with the taxpayer. *See INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992).

To invoke § 7491(a) as to a particular factual issue, a taxpayer needs more than credible evidence with respect to that issue; the taxpayer also must satisfy each of three conditions. Specifically, a taxpayer must prove: "(A) the taxpayer has complied with the requirements under this title to substantiate any item; (B) the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and (C) in the case of a partnership corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii)." *Id.* § 7491(a)(2). The last condition requires that a corporation's net worth not exceed $7,000,000, nor have more than 500 employees. 26 U.S.C. § 7430(c)(4)(A)(ii); 28 U.S.C. § 2412(d)(2)(B).

Most fundamentally, § 7491(a) does not apply here because it applies only with respect to factual issues, and the pending motion addresses only legal issues related to TelexFree's entitlement to claimed deductions. The motion asks this Court to decide whether a Ponzi scheme is a trade or business; whether a Ponzi scheme's deductions must be reasonable in amount; when a Ponzi scheme's promises to its victims are accrued; whether the Trustee has established a bona fide debt owed by the Brazilian part of the Ponzi scheme; and whether assets forfeited by TelexFree's principal can be treated as a casualty loss to TelexFree. Those are legal questions,

not factual ones, which renders § 7491(a)'s burden-shifting framework irrelevant to this motion. *See In re Waters*, 2008 WL 384571, at *7 (Bankr. D. Conn. Feb. 8, 2008) ("[S]ince there remain only legal issues, burden of proof, and, therefore, section 7491, are irrelevant."). If the Court were to find that disputed material facts exist, then the Court should deny summary judgment and hold a trial to resolve the disputed factual issues. *See* Fed. R. Civ. P. 56(a). Only after a trial would the Court be in a position to determine on an issue-by-issue whether the Trustee had put forth "credible evidence" sufficient to shift the burden as to each disputed factual issue.

If the Court addresses § 7491(a), then the Court should hold that the Trustee is not entitled to burden shift under § 7491(a) as to any factual issue because the Trustee has not met the prerequisites. The Trustee bears to burden to establish that he is entitled to shift the burden as to any factual issue, and he cannot meet that burden. *See* S. Rep. No. 105-174, at 45 (1998). Although the United States reserves its ability to raise additional problems with the Trustee's failure to satisfy the burden-shifting requirements if this case were to proceed to trial, there are at least two conditions that have not been met and that preclude burden-shifting at this stage.

First, the Trustee has not established that "*the taxpayer* has maintained all records required under [the Internal Revenue Code]." 26 U.S.C. § 7491(a)(2)(B). In his motion, the Trustee acts as if he (or his agents at KPMG) are "the taxpayer" for the purpose of 26 U.S.C. § 7491(a)(2)(B). The Trustee and his agents are not the taxpayer; TelexFree, LLC, is the taxpayer. And, by the Trustee's own admissions under penalty of perjury, TelexFree did not maintain all records required under the Internal Revenue Code. Specifically, on every return filed by the Trustee on behalf of TelexFree, LLC, the Trustee signed the return under penalty of perjury, and the return contained a disclaimer that it was based on "reconstructed transactional data" or "estimates," or else acknowledged the existence of "inconsistencies" between the Trustee's reconstructed transactional data and "general ledgers." (*See* U.S. Resp. to T'ee S.O.F.

¶ 51.) TelexFree was required to "keep such permanent books of account or records . . . as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person [*i.e.*, a person subject to tax under subtitle A of the Code] in any return of such tax or information." 26 C.F.R. § 1.6001-1(a); *see also* 26 U.S.C. § 6001. TelexFree did not keep the records required, otherwise the Trustee (or KPMG) would not have had to "reconstruct[]" financial data, or rely on estimates, and there would have been no "inconsistencies" between the reconstructions and other general ledgers. The fact that this lack of recordkeeping may be attributable to TelexFree's collapse, and not the fault of the Trustee, is irrelevant to the § 7491(a) inquiry. *See Estate of Cape v. United States*, 2015 WL 5794209, at *14 (E.D. Wis. Oct. 2, 2015) ("[A] confluence of bad events for recordkeeping does not mean the IRS should adjust its substantiation requirements."). Similarly, that the Trustee may have relied on the best available information does not mean that TelexFree maintained all required records. The test is the taxpayer's maintenance of *all required records*, not a bankruptcy trustee's reconstruction of those records based on currently-available information. This distinction is particularly important here because the Trustee had no involvement with TelexFree prior to its collapse and so lacks personal knowledge of TelexFree's pre-collapse recordkeeping. As a result, the Trustee cannot attest to the completeness and accuracy of the records on which the tax returns rely. Consistent with that inability to assure the completeness and accuracy of the underlying returns, the tax returns that the Trustee signed under penalty of perjury recognize that they may be based on estimates or that there are inconsistencies between the reconstructed data and other ledgers. The Trustee has not established that TelexFree maintained all required records, and thus cannot obtain § 7491(a) burden-shifting under any circumstances.

Second, and related to TelexFree's failure to maintain all required records, the Trustee has not presented "credible evidence" as to any factual issues underlying TelexFree's alleged

entitlement to the deductions that the Trustee has claimed. As to facts related to the business expense and bad debt deductions that the Trustee seeks, the only evidence that the Trustee has presented in his competing statement of undisputed facts are the inadmissible hearsay statements of himself and Thomas Greenaway (through their affidavits, tax returns, and documents they sent to the IRS). These hearsay statements are not based on personal knowledge because neither the Trustee nor Mr. Greenaway had any involvement with TelexFree prior to its collapse. Instead, many of their statements are based on the reconstructed financial data described above, which neither can certify is wholly complete or accurate due to their lack of personal knowledge. *See In re Indus. Commercial Elec., Inc.*, 319 B.R. 35, 55 (D. Mass. 2005) (reversing bankruptcy court decision that improperly shifted factual burden related to deductions to IRS, and remanding with direction to allow IRS's claim in full); *Zeeman v. United States*, 275 F. Supp. 235, 256 n.8 (S.D.N.Y. 1967). The tax returns cannot be admitted here because the Trustee and KPMG lack the original books and records of TelexFree and cannot attest to the completeness and accuracy of the reconstructed data on which they relied. The lack of original records prevents this from being a case where a taxpayer's accountant is "familiar with the taxpayer's books and records and sources of income" and makes those books and records available for cross-examination. *Zeeman*, 275 F. Supp. at 256 n.8. Beyond the lack of original records and personal knowledge, the Trustee has presented no evidence to prove that the alleged bad debt for which he seeks to take a bad debt deduction was a "bona fide" debt eligible for such a deduction. Finally, as to the casualty-loss deduction (which should not be considered by this Court), the Trustee has presented a mix of facts of which the Court can take judicial notice and his own inadmissible hearsay statements. The Trustee has not, however, established that the forfeited assets were TelexFree's property, nor has he established the amount of the loss.

The Trustee cannot rely on § 7491(a) to shift the burden of proof as to any factual issues.

B. The judicial exception to the ordinary burden of proof does not apply.

In a two-sentence paragraph, the Trustee misinterprets two Supreme Court decisions to suggest that the United States bears the burden of proof to disprove TelexFree's entitlement to its claimed deductions. (Doc. 65, at 6.) Neither opinion, however, stands for the proposition that the burden of proof regarding a deduction ever shifts to the United States. As a uniform, decades' long body of circuit court case law demonstrates, a taxpayer always bears the burden to demonstrate entitlement to a claimed deduction.

The ordinary burden of proof in tax cases is as follows: Regardless of the type of case, the IRS's tax assessment generally is presumed correct, and the taxpayer bears the burden to overcome that presumption by proving that the assessment is erroneous. *See, e.g.*, *Cavallaro v. Comm'r*, 842 F.3d 16, 20–21 (1st Cir. 2016); *United States v. Rexach*, 482 F.2d 10, 17 (1st Cir. 1973) ("We therefore hold that in tax collection suits or on government counterclaims, as in tax deficiency or refund suits, the burdens of both going forward and ultimate persuasion are on the taxpayer."). A narrow judicial exception to the ordinary burden of proof exists in cases where a tax assessment is based on unreported income. In such cases, when a taxpayer can prove that the IRS's assessment was "arbitrary and excessive," but not the correct tax, the IRS's assessment will not be presumed correct and the court will determine "the correct amount of the tax." *Helvering v. Taylor*, 293 U.S. 507, 515–16 (1935). In dicta, the Supreme Court later explained that an IRS assessment would be "arbitrary and excessive" within the meaning of *Taylor* if it were "a 'naked' assessment without [a]ny foundation whatsoever[.]" *United States v. Janis*, 428 U.S. 433, 441 (1976); *cf. United States v. Walton*, 909 F.2d 915, 919 n.2 (6th Cir. 1990) (explaining that *Janis*'s arbitrary-and-excessive holding was dicta).

The narrow judicial exception to the ordinary burden of proof in tax cases created by *Taylor* and *Janis* does not apply here for two reasons:

First, the *Taylor* and *Janis* exception only applies to tax assessments based on unreported income, not those based on disallowing deductions. *See, e.g.*, *Day v. Comm'r*, 975 F.2d 534, 537 (8th Cir. 1992); *Portillo v. Comm'r*, 932 F.2d 1128, 1133 (5th Cir. 1991); *Zuhone v. Comm'r*, 883 F.2d 1317, 1325 (7th Cir. 1989); *Anastasato v. Comm'r*, 794 F.2d 884, 887 (3d Cir. 1986); *Walker v. Comm'r*, 757 F.2d 36, 41–42 (3d Cir. 1985); *Weimerskirch v. Comm'r*, 596 F.2d 358, 361 (9th Cir. 1979); *Carson v. United States*, 560 F.2d 693, 696 (5th Cir. 1977). The purpose of this exception to the ordinary burden of proof in unreported income cases is to avoid forcing the taxpayer "to prove a negative"—that the taxpayer did not receive income the IRS attributes to him or her. *Weimerskirch*, 596 F.2d at 361 (quoting *Elkins v. United States*, 364 U.S. 206, 218 (1960)). In addition to the practical difficulties of proving a negative, because unreported income cases often involve income from illegal activities, the *Taylor* and *Janis* exception avoids the significant fairness concerns raised by branding the taxpayer a criminal in the absence of any evidence that the taxpayer engaged in illegal activities. *See id.* at 362 (describing assertion that taxpayer had "unreported income from the sale of narcotics" as equivalent to calling the taxpayer a "heroin pusher"). The burden imposed on the United States (or, in Tax Court, the IRS) to avoid application of the exception, and to benefit from the presumption of correctness, is low: the United States merely needs to introduce evidence that links the taxpayer to the income-producing activity. *See, e.g.*, *Hardy v. Comm'r*, 181 F.3d 1002, 1004–05 (9th Cir. 1999); *Day*, 975 F.2d at 537; *Gold Emporium, Inc. v. Comm'r*, 910 F.2d 1374, 1378–79 (7th Cir. 1990); *cf. Erickson v. Comm'r*, 937 F.2d 1548, 1551–52 (10th Cir. 1991).

Courts have consistently distinguished tax assessments based on disallowing deductions from those based on unreported income, and have declined to apply the *Taylor* and *Janis* exception to deduction cases. *See, e.g.*, *Sealy Power, Ltd. v. Comm'r*, 46 F.3d 382, 387 (5th Cir. 1995) ("[T]he burden-shifting principle for unreported income cases should not extend to cases

in which the Commissioner rejects deductions or credits claimed by a taxpayer."); *Foster v. Comm'r*, 756 F.2d 1430, 1439 (9th Cir. 1985) (rejecting taxpayer's *Janis*- and *Weimerskirch*-argument in case involving deduction because those cases' rationale did not extend to deductions); *Gatlin v. Comm'r*, 754 F.2d 921, 923 (11th Cir. 1985) ("This is a deduction case. At all times the taxpayer must come forward with evidence to support his entitlement to the deduction and the amount of that deduction."); *Bennett Paper Corp. v. Comm'r*, 699 F.2d 450, 453 (8th Cir. 1983) (rejecting taxpayer argument that "assessment was arbitrary and unsupported by any evidence whatsoever" because "the burden of proof is on the petitioner in Tax Court to show his right to a claimed deduction"). Instead, the First Circuit (and many other courts) has held that the taxpayer always has the burden to prove its entitlement to a deduction based on specific evidence, and that "[t]here is no burden of proof on the Commissioner to justify his disallowance of a claimed deduction." *Hanover Ins. Co. v. Comm'r*, 598 F.2d 1211, 1219 (1st Cir. 1979); *see also INDOPCO*, 503 U.S. at 84; *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510, 515–16 (6th Cir. 2001); *Sealy Power*, 46 F.3d at 387; *LaBow v. Comm'r*, 763 F.2d 125, 131–32 (2d Cir. 1985); *Karme v. Comm'r*, 673 F.2d 1062, 1065 (9th Cir. 1982); *Foster*, 756 F.2d at 1439. Placing the burden of proof on the taxpayer to prove entitlement to a deduction is consistent with the practicalities of coming forward with evidence related to a deduction, because "the taxpayer has better access to evidence" related to deductions. *United States v. Walton*, 909 F.2d 915, 918 (6th Cir. 1990); *see also Sealy Power*, 46 F.3d at 487 (describing taxpayer as "the best source of information for determining entitlement to [] claimed deductions"). If the *Taylor* and *Janis* exception applied to deductions, it would perpetuate the difficulty—disproving a negative—that the exception sought to prevent, just by saddling the United States with the difficulty instead of the taxpayer. No authority supports such a result.

Second, even if this case involved unreported income (which it does not), the *Taylor* and

Janis exception still would not apply because the assessments that form the basis of the IRS's proofs of claim and requests for payment of administrative expenses are not naked assessments. The Seventh Circuit has provided a particularly clear articulation of what a naked assessment is:

> For the assessment to be void [under *Janis*], it must be more than incorrect, for the correctness of the amount assessed is quite irrelevant. It must be arbitrary in the sense that the calculation has no support and the true amount of tax owed is incapable of being ascertained. Thus, where records supporting an assessment are excluded from evidence, or are nonexistent, so that the basis upon which an assessment is calculated is beyond the knowledge of the court, the assessment is 'arbitrary and erroneous.' It is beyond saving.

United States v. Schroeder, 900 F.2d 1144, 1149 (7th Cir. 1990). In other words, a naked assessment is one in which the IRS has no evidence beyond the assessment itself. *See Coleman v. United States*, 704 F.2d 326, 329 (6th Cir. 1983) (invoking *Janis* exception where no evidence supported assessment, and distinguishing cases involving secondhand records, reasonable methods for estimating unreported income, or proof that original returns were destroyed). A naked assessment is not one that the IRS concedes contains errors, *see Cavallaro*, 842 F.3d at 21, nor is it one based on a legal theory that ultimately turns out to be incorrect, *see In re Burns*, 974 F.2d 1064, 1066 (9th Cir. 1992). A naked assessment is rare, and does not exist if the IRS has *any* evidence to support its assessment. *See, e.g.*, *Cavallaro*, 842 F.3d at 22 (assessment was not naked in light of ambiguous statement by taxpayers' lawyer preceding transaction that led to assessment); *Stuart v. United States*, 337 F.3d 31, 35 (1st Cir. 2003) (assessment was not naked where IRS relied on tax returns filed for earlier tax periods), *abrogation on other grounds recognized by Jennings v. Jones*, 587 F.3d 430, 438 n.10 (1st Cir. 2009); *Estate of Todisco v. Comm'r*, 757 F.2d 1, 6 (1st Cir. 1985) (assessment was not naked in light of evidence that taxpayer earned money from bookmaking). As long as the IRS has some evidence to support an assessment based on unreported income, the exception does not apply, and the court will simply

fix any proven errors in the assessment, not shift the burden of proof. *See Todisco*, 757 F.2d at 4–6 (holding that gross profit margin was too high and remanding for tax to be recalculated based on lower margin). Where, as here, the IRS's assessments were based on returns that TelexFree filed, there is not a naked assessment. *See Stuart*, 337 F.3d at 35.

Neither of the narrow exceptions to the ordinary burden of proof in tax cases has any relevance to this proceeding. The Trustee thus bears the burden to prove TelexFree's entitlement to the deductions he seeks, including any factual issues related to those deductions.

II. The Court should strike or otherwise not rely on the Trustee's statement of undisputed facts.

The Trustee submitted a competing statement of undisputed facts in opposition to this motion, although such a statement is not permitted by the local rules. *See* Local Rule Civ. P. 56.1. In putting forward his own statement of undisputed facts, the Trustee relies almost entirely on inadmissible hearsay in the form of affidavits from himself and his agent, Thomas Greenaway of KPMG. Consistent with Federal Rule of Civil Procedure 56(c)(2), the United States has responded to the overwhelming majority of the Trustee's facts by objecting that the facts are not supported by admissible evidence, based on Federal Rules of Evidence 602[1] and 802. Because, as the proponent of this motion, the United States already put forward a statement of undisputed facts, and the Trustee's competing statement of undisputed facts is based primarily on hearsay and facts as to which the declarants lack personal knowledge, the United States asks the Court to strike, or otherwise not rely on, the Trustee's statement of undisputed facts, and instead to rely on the United States' statement (and the Trustee's responses to it) in deciding this motion.

III. The Trustee has not satisfied his burden to prove TelexFree's entitlement to

[1] Although proffered as an expert witness, Mr. Greenaway's affidavit (Doc. 69) contains primarily facts not properly subject to expert testimony (as to which he lacks personal knowledge), or legal conclusions that are for this Court to decide. In a trial is found necessary, the United States reserves its right to challenge the admissibility of his testimony.

deduct as ordinary and necessary business expenses its promises to its victims pursuant to 26 U.S.C. § 162.

For the reasons explained in the United States' opening brief, the Trustee has not established TelexFree's entitlement to deduct under 26 U.S.C. § 162 its promises to pay its victims extraordinary returns for advertising and recruiting new victims to the Ponzi scheme (recharacterized as the "promotional expenses" by the Trustee). In this section, the United States explains why the Trustee's response does not provide a basis to reach the opposite conclusion.

A. A Ponzi scheme is not a "trade or business" within the meaning of § 162(a).

The Trustee has failed to show that TelexFree, which was at base a Ponzi scheme, was engaged in a "trade or business" within the meaning of 26 U.S.C. § 162(a).

First, this Court should not describe TelexFree's alleged "trade or business" as "the sale of membership plans." (Doc. 65, at 8.) The Trustee wants to call TelexFree's alleged business "the sale of membership plans," which directly contradicts his prior sworn statements. In every tax return that the Trustee filed on behalf of TelexFree for the years 2012 to 2014, which the Trustee signed under penalty of perjury, TelexFree's business activity was listed as direct sales of communications services. (U.S. Resp. to T'ee S.O.F. ¶ 51.) The IRS relied on that sworn representation when it disallowed the deductions the Trustee seeks; TelexFree's promises to its victims were unrelated to direct sales of communications services. (*Id.* ¶ 58.) Moreover, the Trustee's euphemistic "sale of membership plans" obscures what the Trustee asks this Court to hold. The Trustee wants this Court to hold that a Ponzi scheme—or selling rights to part of the proceeds of a Ponzi scheme through "membership plans" in the Ponzi scheme—is a trade or business within the meaning of 26 U.S.C § 162(a). Such a "trade or business" would mean that a taxpayer can be in the business of defrauding victims of their money in exchange for promising those victims money back if they recruit more victims or else advertise the scheme.

Second, the fact that the TelexFree principals incorporated their Ponzi scheme in various LLCs does not make a Ponzi scheme a trade or business. The United States agrees with the Trustee that "[a] for-profit corporation is normally deemed to be engaged in a trade or business." (Doc. 65, at 7.) That general proposition does not help the Trustee, however, because a Ponzi scheme—even when incorporated as a corporate entity—is not a "for-profit corporation," nor a normal corporation. Moreover, the General Counsel Memorandum relied on by the Trustee for that proposition recognizes that not all corporate activities lead to a § 162 deduction. Instead, a "§ 162 deduction should be denied for corporate activities that are not profit motivated." Gen. Counsel Memo. 37071, at *6 (Mar. 30, 1977). "[T]he requirement of a profit-motive" thereby acts as a "safeguard against the deduction of nonbusiness expenses by a corporation." *Id.*; *see also* Gen. Counsel Memo. 37513, at *6 (Apr. 25, 1978) ("A review of section 162 cases indicates that deductions claimed under that section by corporations have been challenged where there was a question whether the activity in question was motivated by some reason other than the corporation's goal of maximizing profits."). If these memoranda are accepted as interpretive authority for the meaning of § 162, as the Trustee requests, then the Court should accept the entirety of the memoranda and deny the Trustee's claimed § 162(a) deductions for TelexFree's promises to its victims because the Ponzi scheme (and activities to further the scheme) was not "profit motivated." As explained in the opening brief (Doc. 55-1, at 5–7), TelexFree could not generate a profit because Ponzi schemes are always insolvent and become increasingly insolvent the longer that they last—a problem that is exacerbated by the principals siphoning significant amounts of money out of the scheme. (Doc. 55-1, at 6.) Because Ponzi schemes serve their principals' personal profit motives, rather than a corporate profit motive, Ponzi schemes are more akin to activities that purely benefit a corporation's shareholders than to profit-motivated corporate activities. Deductions are routinely denied for activities undertaken by a corporation

that solely benefit its shareholders or principals. *See* Gen. Counsel Memo. 37513, at *6–7 (collecting cases) ("[T]hese cases illustrate that the profit motive rather than the extent of activity is relevant in determining whether an activity is a trade or business for a corporation[.]").

Third, the Trustee, perhaps not liking the profit-motive requirement in the General Counsel Memoranda, points out that some formulations of the trade or business test speak of a taxpayer's intent to generate profit *or income*. *See Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987). Although that is true, *Groetzinger* does so in the context of an individual—a normal linguistic choice for talking about the way that an individual earns money. *Groetzinger* goes on to explain that the income at issue in that case, which came from gambling, was "the production of income for a livelihood" and the activity was engaged in "for a livelihood, though with a less-than-successful result." *Id.* at 36; *see also Doggett v. Burnet*, 65 F.2d 191, 193 (D.C. Cir. 1933) (discussing a definition of "business" that includes "the purpose of livelihood or profit" in the context of an individual). Even though the taxpayer in *Groetzinger* failed to profit from his gambling (as his losses exceeded his winnings), the Court's description of his goal shows that he intended to make a profit: he sought to earn his "livelihood" through gambling, and a livelihood assumes an ability to support himself by making more than one spends to earn money. Similarly, in another case cited by the Trustee, the individual taxpayer acted "for the purpose of making a profit, or in the belief that a profit can be realized thereon." *Doggett*, 65 F.2d at 194.

With respect to the only case involving a corporation cited by the Trustee, the court referenced a trade or business as involving an intention to generate profit or income in the context of determining whether activity was solely to benefit the principals personally or else served some independent corporate purpose. *See Int'l Trading Co. v. Comm'r*, 275 F.2d 578 (7th Cir. 1960) (considering deductibility of expenses related to maintaining residential real property primarily for benefit of principals, rather than for corporation's income or profit). Fitting a Ponzi

scheme into that context, the only activity that a Ponzi scheme engages in is to benefit the principals personally because the scheme as an entity can never be profitable.

Fourth, the Trustee appears to misinterpret the United States as contending that a trade or business cannot exist if income is derived by illegal means. (Doc. 65, at 7–8.) The United States does not so contend, as it made clear in its opening brief. (Doc. 55-1, at 7.) Many illegal activities are a trade or business, and allowing the principal of such a business to deduct expenses under § 162. Congress recognized that illegal activities may be a trade or business when it enacted a statute disallowing deductions for expenses incurred in carrying on the trade or business of "trafficking in controlled substances." 26 U.S.C. § 280E. The illegal nature of a Ponzi scheme thus is not the reason it is not a trade or business.

Instead, Ponzi schemes are not outside of the definition of "trade or business" because they are solely vehicles for the enrichment of their principals at the expense of their victims, with no potential to make the corporation a profit. The Trustee is right that the United States did not cite any cases involving Ponzi schemes, and that it because the United States had not found any opinions addressing the question whether a Ponzi scheme is a trade or business. Since then, the United States has found one opinion that touches on that question, and in it the Tax Court held that partnerships engaged in "a coal mining Ponzi scheme" "were not engaged in a trade or business for profit" and thus could not deduct expenses under § 162. *See Kelley v. Comm'r*, T.C. Memo. 1993-495, at *18–19.[2] Much like the TelexFree Ponzi scheme, the Ponzi scheme in *Kelley* had a stated purpose (in *Kelley*, coal mining; here, VoIP sales), and an actual purpose (in both cases, a Ponzi scheme. The Ponzi scheme principals' intent to personally profit did not render the Ponzi scheme at issue in *Kelley* a trade or business. *See id.* Given the paucity of case

[2] The question was presented in *O'Bryon v. Commissioner*, T.C. Memo. 2000-379, but the taxpayer and the IRS settled the issue, and the opinion address only costs and fees.

law on the topic, this Court should follow *Kelley* and hold that a Ponzi scheme is not a trade or business for the purpose of § 162.

This Court also should look to case law involving similar crimes. For example, embezzlement is another fraud, and courts consistently find that it is not a taxpayer's trade or business—not even when the taxpayer engaged in embezzlement with continuity and regularity. *See Hankins v. United States*, 403 F. Supp. 257, 259 (N.D. Miss. 1975) (noting that taxpayer stated he "engag[ed] in a systematic and regular embezzlement of funds"). Much as "rob[bing] the till of [one's] employer" is not a trade or business, *id.*, robbing the pocket of one's victims should not be a trade or business. Consistent with that conclusion, outside of the "trade or business" context, courts have refused to lower civil disgorgement penalties by the amount the penalized defendant spent to earn the money being disgorged. *See United States v. RaPower-3, LLC*, 343 F. Supp. 3d 1115, 1196 & n.633 (D. Utah. 2018).

Finally, the Trustee observes that the United States' trade-or-business argument is of "recent vintage." To the extent that the Trustee makes this observation with the intent of barring the United States from raising the argument, there is no merit to the observation. Because this is a *de novo* proceeding, the United States is not bound by the IRS's reasoning. *See, e.g.*, *Helvering v. Pfeiffer*, 302 U.S. 247, 252 (1937) ("The circumstances that the [Board of Tax Appeals], by the erroneous application of a regule of law to the facts before it arrived at a deficiency which is sustained by a correct application of a different rule, is not ground for setting aside its order." (citation omitted)).

B. The Trustee has not demonstrated that TelexFree's promises to its victims were reasonable in amount.

As an initial matter, 26 U.S.C. § 162(a)(1) imposes a statutory requirement of reasonableness on compensation, and the Trustee appears to maintain that TelexFree's promises

to its victims were compensation. *See* T'ee S.O.F. ¶ 54. The Trustee thus must prove through admissible evidence that the promises represented reasonable compensation.

Even if TelexFree's promises to its victims are not compensation, many courts have recognized that expenses must be reasonable in amount to be deductible under § 162(a) despite the lack of a statutory reasonableness requirement. Indeed, even the Supreme Court has recognized that "extraordinary, unusual and extravagant" expenses are outside of the scope of "ordinary and necessary" expenses. *Botany Worsted Mills v. United States*, 278 U.S. 282, 292 (1929). This reasonableness gloss, or alternatively the prohibition on deducting extraordinary expenses, precludes the deduction of TelexFree's promises to its victims.

There is no merit to the Trustee's attempts to distinguish opinions cited by the United States for the proposition that expenses must be reasonable in order to be deductible under § 162. The Trustee's arguments assume that the cited opinions must have faced exactly the question this Court faces in order to be relevant, thereby ignoring principles of law set forth in the opinions. Although the court in *In re Receivership Estate of Indian Motorcycle Manufacturing, Inc.*, was not deciding whether the expenses at issue were in fact reasonable, the court stated that "*[r]easonable* expenditures made to protect or to protect a taxpayer's business . . . are deductible as ordinary and necessary expenses of the transacting business." 299 B.R. at 27 (emphasis added). Similarly, the Tax Court in *Brallier v. Commissioner*, T.C. Memo. 1986-42, quoted a Ninth Circuit opinion for the proposition that "[a]n expenditure may be, by its nature, ordinary and necessary, but at the same time it may be unreasonable in amount," and "[i]n such a case only the portion which was reasonable would qualify for a deduction under section 162(a)." *Id.* (quoting *United States v. Haskel Eng'g & Supply Co.*, 380 F.2d 786, 789 (9th Cir. 1967)); *see also Boomershine v. Comm'r*, T.C. Memo. 1987-384. And although *Botany Worsted Mills*, involved compensation, for which there is a statutory reasonableness requirement, the Court's

analysis of the phrase "ordinary and necessary expenses" recognized a reasonableness component inherent in that phrase by observing that expenses of "extraordinary, unusual and extravagant amounts . . . having no substantial relation to the measure" of the exchanged services could not be ordinary and necessary expenses. 278 U.S. at 292. Other cases relied on by the United States further a similar principle, which is that expenses for the "personal pleasure and aggrandizement" of a principal are not deductible under § 162 by the corporation. *W.D. Gale, Inc. v. Comm'r*, 297 F.2d 270, 271 (6th Cir. 1961); *see also Hahn v. Comm'r*, T.C. Memo. 1979-429. Ponzi schemes, lacking the ordinary profit-motive of other corporations, are more akin to activities engaged in solely for the aggrandizement of their principals, and thus the expenses incurred to operate them should not be deductible. *Cf. Kelley*, T.C. Memo. 1993-495, at *18–19 (denying § 162 deductions for "outrageously inflated royalties, mine development expenses, and other costs" of "coal mining Ponzi scheme").

The Trustee's argument that the United States must show the unreasonableness of TelexFree's promises to its victims is incorrect. As explained above, the Trustee must prove TelexFree's entitlement to deduct the promises, which includes proof that they were reasonable in amount (or, at least, not extraordinary). The Trustee cannot satisfy that burden because the returns that TelexFree promised its victims were in "extraordinary, unusual and extravagant amounts . . . having no substantial relation" to the value of the services provided. *Botany Worsted*, 278 U.S. at 292; *cf. Kelley*, T.C. Memo. 1993-495, at *18–19. They thus were not ordinary and necessary expenses.

The Trustee wants this Court to hold that there are no limits on what a Ponzi scheme principal can promise his victims and that, as long as he incorporated the scheme, he can deduct the full value of those promises under § 162. Such a holding would incentivize Ponzi scheme principals to find the amount that they can promise victims that will maximize the number of

victims and the amount of money defrauded from those victims. This Court should not reach a conclusion that will incentivize Ponzi scheme principals to maximize victim losses.

C. The all-events test for determining when an expense accrues was not met for TelexFree's promises to its victims until those promises were paid.

The Trustee misinterprets the United States' all-events argument from its opening brief by suggesting that the United States seeks to recharacterize TelexFree as a cash-basis taxpayer. The United States understands that TelexFree is an accrual-basis taxpayer and does not seek to change its method of accounting. Instead, the United States argues, as it did in its opening brief (Doc. 55-1, at 13), that TelexFree did not accrue its promises to its victims until it paid those promises due to the certainty that not all of the promises could be paid.

An accrual-basis taxpayer can accrue an expense under the all-events test when there is a possibility or even a probability that the expense will not be paid. *See Keebey's, Inc. v. Paschal*, 188 F.2d 113, 115 (8th Cir. 1951). But there is a point where there is so much uncertainty about the likelihood of paying an expense that the all-events test will not be met. That point is reached with Ponzi schemes, for which there is not a probability but rather a certainty that it will be unable to pay all of its promises to victims. Cases in which courts conclude that an expense was accrued despite a probability of nonpayment distinguish theoretical circumstances involving a *certainty* of nonpayment. For example, in *Cohen v. Commissioner*, the Tax Court distinguished the case it faced, in which it was doubtful interest sought to be deducted would be paid, from a situation in which there was "certainty that he would be unable to do so [*i.e.*, to pay the interest]." 21 T.C. 855, at 857 (1954); *see also Jorden v. Comm'r*, 11 T.C. 914, 925 (1948) (distinguishing circumstances in which "in no event" will the amount due be paid). With a Ponzi scheme, there is not a probability of nonpayment of the promises to victims, but rather a *certainty* of nonpayment. And unlike other insolvent corporations, for which there is some

theoretical prospect of reorganization or future solvency, a Ponzi has no possibility of ever becoming solvent; it is *per se* insolvent and necessarily will be unable to fulfill all of its promises to victims. (Doc. 55-1, at 5.) Ponzi schemes are never profitable and thus some portion of Ponzi scheme principals' promises to their victims will not be fulfilled. Due to this certainty of nonpayment, the Court should find that the all-events test is not satisfied for Ponzi scheme principals' promises to victims until those promises are fulfilled.

IV. The Trustee has not satisfied his burden to prove TelexFree's entitlement to deduct as a bona fide bad debt pursuant to 26 U.S.C. § 166.

In his opposition, the Trustee failed to address the United States' primary argument related to the bad debt deduction for 2013: the Trustee failed to prove that the deduction is based on a "bona fide" debt. (*See* Doc. 55-1, at 15–17.) The Trustee argues only that the alleged debt should be deductible because it allegedly was included in income and became worthless when Ympactus shut down.[3] (Doc. 65, at 18.) But the test for deductibility of a bad debt pursuant to 26 U.S.C. § 166 does not hinge solely on whether a debt previously had been included in income. Among other requirements, the debt also must have been a "bona fide" debt. *See* 26 C.F.R. § 1.166-1(c). The United States explained in its opening brief why the alleged Ympactus debt was not a bona fide debt, and the Trustee failed to address that argument and identified no evidence that shows a bona fide debt. To the contrary, the Trustee has admitted that Ympactus and TelexFree had the same principals and that Ympactus was merely the Brazilian arm of the scheme that otherwise operated in the same manner as TelexFree. (Doc. 67, at ¶¶ 22–24.) In the absence of evidence like a contract on terms suggesting a true debtor-creditor relationship (*i.e.*, terms that an independent vendor or lender would have agreed to) and adherence to those terms,

[3] The Trustee's factual position is not supported by admissible evidence, and appears to contradict the sworn interrogatory responses. (U.S. Resp. to T'ee S.O.F. ¶¶ 31, 35, 77–82.)

the facts and circumstances do not support the existence of a bona fide debt for the purpose of a § 166 deduction. *See Casco Bank & Trust Co. v. United States*, 544 F.2d 528, 532–33 (1st Cir. 1976) (determining that principal's transaction with his own business did not create bona fide debt); *cf. Indian Motorcycle Mfg.*, 299 B.R. at 28 (holding that receiver "cannot retroactively recharacterize" transaction to obtain deduction). The Court should hold that the Trustee has failed to establish a bona fide debt and thus failed to established that any alleged debt owed by Ympactus is deductible under § 166. The Court also should reject any belated attempts by the Trustee to address this argument when the Trustee chose not to do so in his opposition.

V. The Trustee has not satisfied his burden to prove TelexFree's entitlement to deduct the assets forfeited by James Merrill pursuant to 26 U.S.C. § 165.

As part of his criminal sentencing in 2014, James Merrill, one of the TelexFree Ponzi scheme principals, forfeited to the United States approximately $148 million worth of assets. The Trustee seeks to have TelexFree take a casualty loss deduction under 26 U.S.C. § 165 in the amount of $148,000,000. But the Trustee has not met his burden to show that TelexFree is entitled to a $148,000,000 casualty loss deduction.

As explained in the opening brief, the Court need not address the Trustee's claimed casualty loss at all. (Doc. 55-1, at 17–18.) Count III challenges the IRS's request for payment of administrative expenses for 2014, and that request is based on a return that did not include a casualty loss deduction. (U.S. S.O.F. ¶¶ 55–62; Ex. 4 to U.S. S.O.F.) The Trustee has not explained why the Court should consider the casualty loss when it was not part of the return that formed the basis for the request for payment of administrative expenses.

Even if the Court were to consider the deduction, however, the Trustee has not established TelexFree's entitlement to a $148,000,000 casualty loss deduction. The Trustee focuses on the fact that Merrill forfeited the assets and that TelexFree was not formally indicted

or criminally penalized, but that distinction does not render the amount of Merrill's forfeiture deductible by TelexFree. Section 162(f) provides that "no deduction otherwise allowable shall be allowed under this chapter [which includes § 165] for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or government entity in relation to the violation of any law[.]" 26 U.S.C. § 162(f)(1). The regulation promulgated thereunder clarifies that § 162(f) applies to amounts paid to the United States pursuant to a guilty plea. *See* 26 C.F.R. § 1.162-21(a)(1), (b)(1)(i). Section 162(f)'s disallowance of fines and similar penalties paid pursuant to a guilty plea is not limited in the statute, or the regulation, to fines and similar penalties paid by the taxpayer. The fact that Merrill, and not TelexFree, formally forfeited the assets is thus irrelevant. Because Merrill forfeited the assets as part of his guilty plea, and forfeiture is a fine or similar penalty that is not deductible, § 162(f) precludes TelexFree from deducting the forfeiture under § 165. *Cf. Nacchio v. United States*, 924 F.3d 1370, 1375 (Fed. Cir. 2016); *King v. United States*, 152 F.3d 1200, 1202 (9th Cir. 1998); *Wood v. United States*, 863 F.2d 417, 422 (5th Cir. 1989).

Much as the fact that Merrill, not TelexFree, forfeited the assets is not relevant to their deductibility, what the United States chose to do with the forfeited assets is not relevant. When Merrill forfeited the assets to the United States as part of his guilty plea, those forfeited assets became property of the United States. The United States' choice to use the forfeited assets for restitution to victims does "not transform the character of [Merrill's] forfeiture so that it was no longer a 'fine or similar penalty' under § 162(f)." *Nacchio*, 824 F.3d at 1380.

Finally, the Trustee is asking the Court to take inconsistent positions with respect to the forfeited assets. On the one hand, the Trustee takes pains to distinguish TelexFree from its former principal, Merrill, and argue that the forfeiture does not bar a casualty deduction because Merrill, not TelexFree, forfeited the assets. On the other hand, the Trustee wants to treat the

assets as all belonging to TelexFree at the time that Merrill made the forfeiture, in order to take a deduction for the full value of those assets. If the assets belonged to TelexFree, then TelexFree should be treated as having consented to the forfeiture or having effectively forfeited the assets itself by not contesting the forfeiture, in which case TelexFree did not suffer a deductible loss because criminal forfeitures are not deductible. Alternatively, if the assets did not belong to TelexFree (either because they rightfully belonged to its victims, or else because they belonged to other persons and entities, such as Merrill), then TelexFree did not suffer a deductible loss because its assets were not seized. Under either view, the Court should hold that the Trustee has not established TelexFree's entitlement to a $148,000,000 casualty loss deduction.

Conclusion

For the reasons stated in its opening brief and this reply brief, the United States requests that the Court grant the United States' Second Motion for Partial Summary Judgment.

Dated: November 25, 2019

Respectfully submitted,

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

/s/ Lauren E. Hume
LAUREN E. HUME
Trial Attorney, Tax Division
U.S. Department of Justice
P.O. Box 55
Washington, D.C. 20044
202-307-2279 (v)
202-514-5238 (f)
Lauren.E.Hume@usdoj.gov

CERTIFICATE OF SERVICE

I hereby certify that on this 25th day of November, 2019, I electronically filed the foregoing document with the Clerk of Court using the CM/ECF system, which will send notification of such filing to all registered CM/ECF participants. There are no parties that require conventional

service.

/s/ Lauren E. Hume
LAUREN E. HUME
Trial Attorney
United States Department of Justice, Tax Division

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,	)	Adv. Proc. No. 18-04091
	)	
Plaintiff and Counterclaim Defendant,	)	Judge Melvin S. Hoffman,
	)	
v.	)	
	)	
UNITED STATES OF AMERICA, DEPARTMENT OF TREASURY, INTERNAL REVENUE SERVICE,	)	
	)	
Defendant and Counterclaim Plaintiff.	)	

UNITED STATES OF AMERICA'S RESPONSE TO TRUSTEE'S STATEMENT OF UNDISPUTED FACTS

Defendant and Counterclaim Plaintiff United States of America, named and sued as "United States of America, Department of Treasury, Internal Revenue Service," hereby objects to the Trustee's 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 (Doc. 66). Local Rule of Civil Procedure 56.1, made applicable to this proceeding by Local Rule of Bankruptcy Procedure 7056, directs the party moving for summary judgment to include "a concise statement of the material facts of record as to which the moving party contends there is no genuine issue to be tried[.]" The local rule directs the party opposing summary judgment to

include "a concise statement of the material facts of record as to which it is contended that there exists a genuine issue to be tried[.]" The local rules do not permit a party responding to a motion for summary judgment to submit its own statement of undisputed facts. In violation of Local Rule 56.1, the Trustee filed a statement of disputed material facts (Doc. 67), and a statement of undisputed material facts, although such a statement is not authorized by the local rules. The United States requests that the Court strike from the record or otherwise refuse to consider the Trustee's improper statement of undisputed facts, which is Document 66 on the docket.

The United States incorporates by reference its statement of material facts. *See* Doc. 54.[1] Although the United States contends that it has no obligation to respond to the Trustee's unauthorized competing statement of undisputed facts, and subject to its position that the Court should strike or otherwise refuse to consider the statement, the United States submits these responses (non-italic) to the Trustee's statement of facts (*in italics*):

1. Ostensibly, TelexFree operated as a multi-level marketing ("MLM") company engaged in the business of selling a voice over internet protocol service, or "VoIP" for a monthly charge of $49.90 to conduct international phone calls. Affidavit of Stephen Darr as he is the Chapter 11 Trustee of the Debtors in Support of the Opposition to the United States of America's Second Motion for Partial Summary Judgment, at ¶ 1 (hereinafter "Darr at ¶ _____").

RESPONSE: The United States objects to Paragraph 1 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c) (defining "hearsay"), 802 (setting forth the rule against hearsay); *Davila v. Corporacion De Puerto Rico Para La Difusion Publica*, 498 F.3d 9, 17 (1st Cir. 2007) ("It is black-letter law that hearsay evidence cannot be considered on summary judgment."). The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 1. *See* Fed. R. Evid. 602.

2. However, revenues from the sale of VoIP plans constituted less than one percent

[1] References to specific paragraphs in the United States' Statement of Undisputed Facts are stated as "U.S. S.O.F. ¶," followed by the applicable paragraph number.

of total revenues and in fact TelexFree operated a Ponzi and pyramid scheme using an MLM structure to sell membership plans. See Memorandum and Order, dated November 25, 2015, Docket No. 654, finding that the Debtors "operated a Ponzi and pyramid scheme"; Darr at ¶ 2.

RESPONSE: The United States objects to Paragraph 2 to the extent that it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 2 to the extent that it is based on the Trustee's affidavit because the Trustee lacks personal knowledge of the facts alleged in Paragraph 2. *See* Fed. R. Evid. 602. The United States admits that the Court has found that the Debtors operated a Ponzi and pyramid scheme.

3. Ponzi schemes and pyramid schemes require a constant flow of new capital to continue operating. TelexFree devised a system to incentivize Participants to join TelexFree, to purchase membership plans, and to recruit others to join TelexFree and purchase membership plans. Because of the incentives, TelexFree grew exponentially, generating more than $3,000,000,000 in revenues in less than three years. Darr at ¶ 3.

RESPONSE: The United States objects to Paragraph 3 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 3. *See* Fed. R. Evid. 602.

4. At the time this adversary proceeding was commenced, TelexFree's net worth was less than $7,000,000 and it employed less than 500 people. Darr at ¶ 4.

RESPONSE: The United States objects to Paragraph 4 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 4. *See* Fed. R. Evid. 602.

5. The Participants were referred to as promoters in their contract with TelexFree. Darr at ¶ 5.

RESPONSE: The United States objects to Paragraph 5 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17.

Paragraph 5 presents inadmissible "hearsay within hearsay." *See United States v. Patrick*, 248 F.3d 11, 22 (1st Cir. 2001) (affirming district court's exclusion as inadmissible of "hearsay within hearsay"). The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 5. *See* Fed. R. Evid. 602.

6. The TelexFree contract specified how Participants could earn credits. Darr at ¶ 6.

RESPONSE: The United States objects to Paragraph 6 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 6 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 6. *See* Fed. R. Evid. 602.

7. Once a membership plan was purchased, Participants could earn credits for promoting TelexFree's business by posting internet advertisements and for recruiting other Participants (the "Promotional Expenses"). Darr at ¶ 7.

RESPONSE: The United States objects to Paragraph 7 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 7. *See* Fed. R. Evid. 602.

8. Each time that a Participant purchased a membership plan or VoIP package, an account ("User Account") was established with SIG, the Debtors' computerized recordkeeping system. During the operation of the TelexFree business, more than 1,000,000 Participants opened more than 11,000,000 User Accounts. Darr at ¶ 8.

RESPONSE: The United States objects to Paragraph 8 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 8. *See* Fed. R. Evid. 602. The United States objects to Paragraph 8 because it is based on reconstructed financial data as to which the Trustee cannot certify the completeness or the

accuracy.

9. After a User Account was established, SIG tracked the activity of the Participant in that User Account, including the accumulation of credits for promotional activities on behalf of TelexFree, the use of credits, and payments made to or from a Participant directly with the Debtors. Darr at ¶ 9.

RESPONSE: The United States objects to Paragraph 9 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 9. *See* Fed. R. Evid. 602.

10. Credits earned for promotional activities could be immediately redeemed for cash, or applied in satisfaction of an invoice for the purchase of a membership plan. Darr at ¶ 10.

RESPONSE: The United States objects to Paragraph 10 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 10. *See* Fed. R. Evid. 602.

11. A Participant could monetize his/her accumulated credits by recruiting a new Participant to join TelexFree and using his/her accumulated credits to satisfy the invoice for the new Participant's membership plan in exchange for payment of the membership fee from the new Participant ("Triangular Transaction"). In a Triangular Transaction, TelexFree issued the membership invoice that was due to TelexFree to the recruited Participant, the recruited Participant paid the TelexFree membership invoice to the recruiting Participant, and TelexFree redeemed the credits of the recruiting Participant in satisfaction of the invoice. Darr at ¶ 11.

RESPONSE: The United States objects to Paragraph 11 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 11. *See* Fed. R. Evid. 602.

12. Based upon the SIG records, the following chart accurately reflects the amount of credits issued to Participants and redeemed by Participants for 2012, 2013, and 2014:

Credits Issued and Redeemed

Year	***Issued***	***Redeemed for Membership Plan***	***Redeemed for Cash***	***Total Redeemed***
2012	*$ 4,261,846*	*$ 3,407,954*	*$ 853,892*	*$ 4,261,846*
2013	*$ 972,955,648*	*$ 843,475,755*	*$ 68,144,795*	*$ 911,620,550*
2014	*$2,442,705,606*	*$1,866,795,376*	*$ 83,212,109*	*$1,950,007,485*

Darr at ¶ 12.

RESPONSE: The United States objects to Paragraph 12 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 12 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 12. *See* Fed. R. Evid. 602. The United States objects to Paragraph 12 because it is based on reconstructed financial data as to which the Trustee cannot certify the completeness or the accuracy.

13. TelexFree operated its business on a full-time basis. Darr at ¶ 13.

RESPONSE: The United States objects to Paragraph 13 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 13. *See* Fed. R. Evid. 602.

14. TelexFree retained full-time employees, rented office space in Marlborough, Massachusetts, contracted with vendors in the ordinary course of business, and entered into contracts with Participants. Darr at ¶ 14.

RESPONSE: The United States objects to Paragraph 14 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 14. *See* Fed. R. Evid. 602.

15. TelexFree reported income in each year of its operation and reported a profit in 2012. Darr at ¶ 15.

RESPONSE: The United States objects to Paragraph 15 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 15. *See* Fed. R. Evid. 602. The United States objects to Paragraph 15 to the extent that it is based on reconstructed financial data as to which the Trustee cannot certify the completeness or the accuracy.

TelexFree Tax Filing Status

16. The Trustee and KPMG reported all TelexFree activity on the amended returns filed on behalf of TelexFree, LLC, as it was the primary operating entity and because it was impossible to separate the activity attributable to any individual entity. Tax returns reporting no activity were filed for TelexFree, Inc. and TelexFree Financial, Inc. Affidavit of Thomas Greenaway in Support of the Opposition to the United States of America's Second Motion for Partial Summary Judgment, at ¶5 (hereinafter "Greenaway at ¶ ____").

RESPONSE: The United States objects to Paragraph 16 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 16. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that the Trustee and KPMG included TelexFree's business operations on returns filed on behalf of TelexFree, LLC, because it was impossible to separate the activity attributable to any individual debtor entity.

17. TelexFree, LLC is a C corporation for U.S. federal income tax purposes. Greenaway at ¶ 6.

RESPONSE: The United States admits that TelexFree, LLC, is a C corporation for federal income tax purposes.

18. TelexFree, LLC files federal income tax returns on a calendar-year basis. Greenaway, at ¶7.

RESPONSE: The United States admits that TelexFree, LLC, is required to file federal income

tax returns on a calendar-year basis.

19. TelexFree, LLC has never engaged in the trade or business of farming. Greenaway, at ¶8.

RESPONSE: The United States objects to Paragraph 19 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 19. *See* Fed. R. Evid. 602.

20. TelexFree, LLC has never performed services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Greenaway, at ¶9.

RESPONSE: The United States objects to Paragraph 20 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 20. *See* Fed. R. Evid. 602.

21. TelexFree, LLC used the accrual method of accounting for computing taxable income. Accordingly, TelexFree, LLC is required to include an item of income in gross income when all events fixing TelexFree, LLC's right to receive the income have occurred and the amount of the income can be calculated with reasonable accuracy. Greenaway, at ¶10.

RESPONSE: The United States objects to Paragraph 21 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 21. *See* Fed. R. Evid. 602. The United States objects to the second sentence of Paragraph 21 because it improperly states a legal conclusion. *See Nieves-Villanueva v. Soto-Rivera*, 133 F.3d 92, 99 (1st Cir. 1997) (joining seven other circuit courts in holding that testimony as to legal conclusions is prohibited by Federal Rules of Evidence). Subject to those objections, the United States admits that TelexFree, LLC, used the accrual method of accounting for computing taxable income. The United States contends that 26 U.S.C. § 461, any regulations

promulgated thereunder, and case law interpreting that statute and regulation determine when an accrual-basis taxpayer may recognize an expense as a deduction.

22. Under the accrual method of accounting, TelexFree is entitled to claim deductions for a liability incurred in the taxable year in which: (i) all events have occurred to establish the fact of the liability; (ii) the amount of the liability can be determined with reasonable accuracy; and (iii) economic performance has occurred with respect to the liability. Greenaway, at ¶11.

RESPONSE: The United States objects to Paragraph 22 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 22 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99. Subject to those objections, the United States admits that 26 U.S.C. § 461 authorized TelexFree, LLC, as an accrual-basis taxpayer, to claim deductions with respect to any item if, with respect to that item, "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."

23. In contrast to the accrual method, the cash method of accounting requires taxpayers to record revenue when cash is received and to record expenses when the expenses are paid. Greenaway, at ¶12.

RESPONSE: The United States objects to Paragraph 23 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 23 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99. The United States objects to Paragraph 23 because the legal conclusion contained therein is irrelevant. Subject to those objections, the United States admits that the cash receipts and disbursements method of accounting requires taxpayers to recognize revenue when cash is received and expenses when the expenses are paid.

24. The government did not provide any notice to TelexFree to properly change TelexFree's method of accounting from accrual to cash. Greenaway, at ¶13.

RESPONSE: The United States objects to Paragraph 24 because it is based on inadmissible

hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 24 because the fact alleged therein is irrelevant, as the United States has not attempted to change TelexFree's method of accounting. Subject to those objections, the United States admits that neither the United States nor the Internal Revenue Service ("IRS") has provided notice to TelexFree of an intent to change its method of accounting.

25. TelexFree maintained adequate and accurate books and records reflecting income and expenses arising from both direct transactions and triangular transactions involving the sale of membership plans. Such income and expenses were reported on TelexFree's returns. Greenaway, at ¶14.

RESPONSE: The United States objects to Paragraph 25 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 25. *See* Fed. R. Evid. 602. The United States objects to Paragraph 25 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99. Subject to those objections, the United States denies that TelexFree maintained adequate and accurate books and records reflecting income and expenses. To the contrary, the Trustee has signed under penalty of perjury returns on behalf of TelexFree that include disclaimers that the returns were based on "reconstructed transactional data" or "estimates," or else acknowledge the existence of "inconsistencies" between the Trustee's reconstructed transactional data and "general ledgers." (*See* Ex. 3 to U.S. S.O.F. at 2; Ex. 4 to U.S. S.O.F. at 22; Ex. 5 to U.S. S.O.F. at 4; Ex. 9 to U.S. S.O.F. at 3; Ex. 11 to U.S. S.O.F. at 5.) Beyond the reliance on reconstructions, estimates, and data that has or may have inconsistencies with TelexFree's general ledgers, the Trustee's need to amend each return to substantively change the items reported on the return further suggests that TelexFree did not maintain adequate and accurate books and records reflecting income and

expenses. Moreover, as Thomas Greenaway had no personal involvement with TelexFree prior to its collapse, he lacks personal knowledge sufficient to attest to the completeness and accuracy of the reconstructed data that forms the basis of TelexFree's returns.

26. Economic performance as to the Promotional Expenses occurred when the Participants performed the promotional activities. Greenaway, at ¶15.

RESPONSE: The United States objects to Paragraph 26 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 26. *See* Fed. R. Evid. 602. The United States further objects to Paragraph 26 because it improperly states a legal conclusion, and the legal conclusion that it improperly states is one of the key legal questions to be decided by the Court for this motion. *See Nieves-Villanueva*, 133 F.3d at 99. Subject to those objections, the United States denies that economic performance as to the promises that TelexFree made to the victims of its Ponzi scheme occurred when the victims advertised the scheme or recruited additional victims to the scheme. Because it was a certainty that TelexFree would be unable to fulfill all of those promises, economic performance as to the promises occurred only as TelexFree satisfied the promises.

2012 Returns

27. On September 9, 2013, TelexFree, LLC filed an original federal income tax return, Form 1120, for the 2012 tax year, reporting tax of $686,121. Greenaway, at ¶16.

RESPONSE: The United States admits that, in September 2013, TelexFree, LLC, filed a Form 1120, for the tax period ending December 31, 2012, which reported tax due of $686,121. *See* U.S. S.O.F. ¶ 34.

28. TelexFree, LLC made payments to the Service of $706,713.79 and $179,986.86 on October 16, 2013 and December 12, 2013, respectively, for the 2012 tax year, of which $686,121 is tax and $200,579 is penalties and interest. Greenaway, at ¶17.

RESPONSE: The United States admits that TelexFree, LLC, made a payment of $706,713.79 on

October 16, 2013, and a payment of $179,986.86 on December 12, 2013, which fully paid its income tax of $686,121 and all related interest and penalties. *See* U.S. S.O.F. ¶ 34.

29. On September 9, 2016, the Chapter 11 Trustee filed on behalf of TelexFree, LLC an amended federal income tax return, Form 1120X, for the 2012 tax year, reporting no tax liability and requesting a refund of amounts paid of $886,700 with respect to its 2012 tax year ("2012 Return"). Greenaway, at ¶18.

RESPONSE: The United States objects to Paragraph 29 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 29 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 29. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that, on or about September 9, 2016, the Trustee sent the IRS a Form 1120X for the tax period ending December 31, 2012, which reported no tax due and requested a refund of $692,854 previously paid toward TelexFree's 2012 income taxes. The United States denies that TelexFree owed no taxes for the tax period ending December 31, 2012, and denies that the Trustee was entitled to the refund requested. *See* U.S. S.O.F. ¶¶ 35–37.

30. On October 31, 2017, the Service disallowed TelexFree, LLC's 2012 refund claim based on its determination that the Promotional Expenses were not deductible under Section 162(a) of the Internal Revenue Code. Greenaway, at ¶19.

RESPONSE: The United States admits that the IRS disallowed the claim for refund contained on the Form 1120X for 2012. *See* U.S. S.O.F. ¶ 37. The United States further admits that the IRS's determination that TelexFree's promises to pay its victims were not deductible under 26 U.S.C. § 162 formed one, but not the only, reason for the IRS's disallowance of the refund claim. *See* Exhibit 6 to U.S. S.O.F. (Doc. 54-6), at 4–5 (listing as additional reasons for disallowance the failure to adequately substantiate expenses, the failure to satisfy the requirements of 26 U.S.C. § 461, and the deduction of estimated amounts). In any event, the United States is not

bound by the IRS's reasoning in this action, because this Court is to determine *de novo* whether the Trustee has established that TelexFree is entitled to certain categories of claimed deductions and, therefore, made an overpayment for tax year 2012. *See, e.g.*, *Lewis v. Reynolds*, 284 U.S. 281, 293 (1932) (holding that, in refund suit, court must determine correct tax liability and taxpayer bears burden to establish entitlement to refund), *modified on other grounds*, 294 U.S. 599.

31. On March 9, 2018, the Chapter 11 Trustee filed on behalf of TelexFree LLC a second amended federal income tax return, Form 1120X, for the 2012 tax year ("2012 Amended Return"). The 2012 Amended Return reported that TelexFree, LLC had no tax liability for the 2012 tax year. The 2012 Amended Return reported gross receipts of $18,220,915, including $11,869,444 in income from a Brazilian affiliate Ympactus Commercial Ltda ("Ympactus"), and a deduction for Promotional Expenses of $4,261,846, and a net loss carryback from 2014 in the amount of $13,435,861. Greenaway, at ¶20.

RESPONSE: The United States objects to Paragraph 31 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 31 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 31. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that, on or about March 7, 2018, the Trustee submitted a second Form 1120X to the IRS for the tax period ending December 31, 2012, which reported that TelexFree had $18,220,915 in gross receipts or sales, claimed a deduction for "gross credit liability accrual" of $4,261,846 and a net operating loss deduction of $13,435,861, and reported no tax due. *See* U.S. S.O.F. ¶ 38. The United States denies that the income reported on the second Form 1120X included $11,869,444 in income from Brazilian Affiliate Ympactus Commercial Ltda ("Ympactus"), which is a factual allegation that is contradicted by the Trustee's sworn interrogatory response that stated that the $18,220,915 in gross receipts for 2012 included $2,943,517 in cash; $3,407,954 in credit redemptions, $87,525 from VoIP service sales; and $6,152,768 from

membership plan sales. *See* U.S. S.O.F. ¶ 37. Subtracting this income from credit redemptions, VoIP service sales, and membership plan sales from the $18,220,915 in gross receipts reported on the second Form 1120X results in at most $8,572,668 that potentially could have included income from Ympactus on the Form 1120X.

32. A true and accurate copy of the 2012 Amended Return is annexed to the Greenaway Affidavit. Greenaway at ¶21.

RESPONSE: A true and accurate copy of the second Form 1120X for the tax period ending December 31, 2012, with its accompanying cover letter to the IRS, is Exhibit 5 to the U.S. S.O.F. To the extent that Exhibit 2 to the Greenaway Affidavit is identical to Exhibit 5 to the U.S. S.O.F., it also is a true and accurate copy of the second Form 1120X for the tax period ending December 31, 2012. To the extent that the Trustee seeks to rely on the second Form 1120X for the tax period ending December 31, 2012, for the truth of any matters asserted therein, the document is inadmissible hearsay. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17.

2013 Returns

33. On September 9, 2016, the Chapter 11 Trustee filed on behalf of TelexFree, LLC an original federal income tax return, Form 1120, for the 2013 tax year, which reported no tax liability and requested a refund of the estimated prepetition payment made by TelexFree with respect to its 2013 tax year in the amount of $15,792,982 ("2013 Return"). Greenaway at ¶22.

RESPONSE: The United States objects to Paragraph 33 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 33 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 33. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that, on or about September 9, 2016, the Trustee sent the IRS a Form 1120 for the tax period ending December 31, 2013, which requested a refund of $15,858,111 in payments made

in March 2014 toward TelexFree's 2013 income taxes, although TelexFree had only made $15,792,982 of such payments. *See* U.S. S.O.F. ¶¶ 35, 42–44.

34. On December 26, 2016, after processing the 2013 Return, the Service issued a refund of $15,532,440 to the Chapter 11 Trustee related to TelexFree, LLC's 2013 tax year (the "2013 Refund") based on the 2013 Return. The 2013 Refund was made up of three components: estimated taxes paid of $15,792,982, plus accrued interest of $55,318, less a $315,860 bad check penalty. The Chapter 11 Trustee filed a penalty abatement request for the bad check penalty, which has not yet been allowed by the Service. Greenaway at ¶23.

RESPONSE: The United States admits that, on or about December 26, 2016, an IRS computer system erroneously generated a refund of $15,532,440.39, which it sent to the Trustee. The United States further admits that the $15,532,440.39 erroneous refund represented the $15,792,982 that TelexFree paid toward its 2013 income taxes, minus a dishonored check penalty of $315,859.64, and that an additional $55,318.03 in interest was credited to TelexFree's 2013 account. *See* U.S. S.O.F. ¶ 45. The United States denies that the Form 1120 for 2013 was "process[ed]"; at the time of the erroneous refund it had been selected for examination and no refund should have been able to be generated. *See id.* The United States contends that any request for an abatement of the dishonored check penalty is irrelevant to this motion, but admits the last sentence of Paragraph 34 for the purpose of this motion.

35. On March 9, 2018, the Chapter 11 Trustee filed on behalf of TelexFree LLC an amended federal income tax return, Form 1120X, for the 2013 tax year ("2013 Amended Return"). The 2013 Amended Return reported that TelexFree, LLC had no tax liability for the 2013 tax year. The 2013 Amended Return reported gross receipts of $1,173,886,556, including $174,183,645 in income from Ympactus, and reported deductions for Promotional Expenses of $972,955,648 and for a bad debt deduction relating to Ympactus of $186,344,898. Greenaway at ¶24.

RESPONSE: The United States objects to Paragraph 35 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 35 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts

alleged in Paragraph 35. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that, on or about March 7, 2018, the Trustee submitted a Form 1120X to the IRS for the tax period ending December 31, 2013, which reported that TelexFree had $1,173,886,556 in gross receipts, claimed a deduction of $972,955,648 for "gross credit liability accrual" and a bad debt deduction of $186,344,898 related to Ympactus, and reported no tax due. *See* U.S. S.O.F. ¶¶ 50–52; Exhibit 9 to U.S. S.O.F., at 4. The United States denies that the income reported on the Form 1120X included $174,183,645 in income from Ympactus, which is a factual allegation that is contradicted by the Trustee's sworn interrogatory response that stated that the $1,173,886,556 in gross receipts for 2013 included $156,227,156 in cash; $843,475,755 in credit redemptions; $65,633,371 from VoIP service sales; and $934,252,624 from membership plan sales. *See* U.S. S.O.F. ¶ 51. This income from credit redemptions, VoIP service sales, and membership plan sales, when combined, exceeds the $1,173,886,556 in gross receipts reported on the Form 1120X, leaving no amount of gross receipts that potentially could have included income from Ympactus on the Form 1120X.

36. A true and accurate copy of the 2013 Amended Return is annexed to the Greenaway Affidavit. Greenaway at ¶25.

RESPONSE: A true and accurate copy of the Form 1120X for the tax period ending December 31, 2013, is Exhibit 9 to the U.S. S.O.F. To the extent that Exhibit 3 to the Greenaway Affidavit is identical to Exhibit 9 to the U.S. S.O.F., it also is a true and accurate copy of the Form 1120X for the tax period ending December 31, 2013. To the extent that the Trustee seeks to rely on the Form 1120X for the tax period ending December 31, 2013, for the truth of any matters asserted therein, the document is inadmissible hearsay. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17.

37. On April 25, 2017, the Service issued Notices of Proposed Adjustment ("NOPA") related to TelexFree, LLC's 2013 Return, proposing to disallow deductions for (i) TelexFree's

advertising and commission credits of $2,161,645,140 and $622,588,034, respectively, and (ii) the bad debt of $186,344,898 related to amounts due from Ympactus, and proposing a late-filing penalty of $75,126,857. Greenaway at ¶26.

RESPONSE: The United States objects to Paragraph 37 because the facts alleged therein are irrelevant to this *de novo* proceeding. Subject to that objection, the United States admits the facts in Paragraph 37.

38. On June 28, 2017, Thomas Greenaway of KPMG on behalf of the Trustee responded to the NOPA and provided the Service with substantiation for the deductions taken on behalf of TelexFree for the 2013 Return. ("KPMG 2013 Response"). Greenaway at ¶27.

RESPONSE: To the extent that Paragraph 38 relies on Exhibit 4 to the Greenaway Affidavit, the United States objects that Exhibit 4 does not support the facts contained in Paragraph 38. Exhibit 4 is a letter from Thomas Greenaway of KPMG to a trial attorney that formerly represented the United States in this adversary proceeding; it is not a response to the IRS to the IRS's Notices of Proposed Adjustment for the tax period ending December 31, 2013. The United States objects to Paragraph 38 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 38 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. Subject to those objections, the United States denies that Thomas Greenaway or the Trustee adequately substantiated the deductions taken on behalf of TelexFree on any return related to tax year 2013.

39. A true and accurate copy of the KPMG 2013 Response is annexed to the Greenaway Affidavit. Greenaway at ¶28.

RESPONSE: The United States denies that Exhibit 4 to the Greenaway Affidavit, described by the Trustee as the "KPMG 2013 Response," is a response by Thomas Greenaway of KPMG to the IRS's Notices of Proposed Adjustment. *See* U.S. Response to Paragraph 38, *supra*. To the extent that the Trustee seeks to rely on the "KPMG 2013 Response" for the truth of any matters asserted therein, the document is inadmissible hearsay. *See* Fed. R. Evid. 801(c), 802; *Davila*,

498 F.3d at 17.

40. On October 31, 2017, the Service issued a statutory notice of deficiency for tax year 2013 related to the NOPAs issued on April 25, 2017. In the notice of deficiency, the Service took the position that TelexFree's 2013 taxable income was $858,592,137 and proposed an increase in tax in the amount of $300,507,248, and a late-filing penalty of $75,126,857. Greenaway at ¶29.

RESPONSE: The United States admits that, on October 31, 2017, the IRS issued a statutory notice of deficiency to TelexFree, LLC, regarding the tax period ending December 31, 2013, in which it increased TelexFree's $300,507,248 and imposed a $75,126,857 penalty pursuant to 26 U.S.C. § 6651(a)(1). The IRS's notice of deficiency was based on its determination that TelexFree had $858,592,137 in taxable income. *See* U.S. S.O.F. ¶¶ 47–48.

2014 Returns

41. On July 6, 2017, the Chapter 11 Trustee filed on behalf of TelexFree LLC an original federal income tax return, Form 1120, for the 2014 tax year, which reported no tax liability ("2014 Return"). Greenaway at ¶30.

RESPONSE: The United States objects to Paragraph 41 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 41 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 41. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that, on or about June 20, 2017, the Trustee sent the IRS a Form 1120 for the tax period ending December 31, 2014, which reported no tax due. *See* U.S. S.O.F. ¶ 55.

42. On November 7, 2017, the Service issued NOPAs related to TelexFree, LLC's 2014 tax year, proposing to disallow TelexFree's deduction for Promotional Expenses totaling $2,442,705,606 and the net operating loss deduction, and proposing a late-filing penalty of $13,481,991. Greenaway at ¶31.

RESPONSE: The United States objects to Paragraph 42 because the facts alleged therein are irrelevant to this *de novo* proceeding. Subject to that objection, the United States admits that, on

November 7, 2017, the IRS issued Notices of Proposed Adjustment related to the tax return described in Paragraph 41, in which it proposed to disallow a deduction for advertising credit expenses of $2,442,705,606 and a net operating loss deduction of $2,578,363,363, and proposed to assess a failure-to-file penalty of $13,481,991. *See* U.S. S.O.F. ¶ 56.

43. On November 8, 2017, Thomas Greenaway of KMPG on behalf of the Trustee responded to the NOPA disputing the disallowance for the 2014 Return. Greenaway at ¶32.

RESPONSE: The United States objects to Paragraph 41 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 41 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 41. *See* Fed. R. Evid. 602. The United States objects to Paragraph 43 because the facts alleged therein are irrelevant to this *de novo* proceeding. Subject to those objections, the United States admits that Thomas Greenaway responded to the NOPA and disputed the disallowance for tax year 2014.

44. KPMG returned the 2014 NOPAs to the Service, noting that the Trustee disagreed with the findings. TelexFree's opposition was based upon substantially the same grounds as set forth in the KPMG 2013 Response. Greenaway at ¶33.

RESPONSE: The United States denies that "KPMG returned the 2014 NOPAs to the Service," because the meaning of that phrase is unclear. The United States admits that the Trustee disagreed with the proposed adjustments described in Paragraph 42. The United States restates its objection to the "KPMG 2013 Response" on the grounds stated in its responses to Paragraphs 38 and 39, *supra*.

45. On March 9, 2018, the Chapter 11 Trustee filed on behalf of TelexFree, LLC an amended federal income tax return, Form 1120X, for the 2014 tax year ("2014 Amended Return"). The 2014 Amended Return reported that TelexFree, LLC had no tax liability for the 2014 tax year. The 2014 Amended Return reported gross receipts of $2,067,416,945, and reported deductions for Promotional Expenses of $2,442,705,606 and a casualty loss of $148,000,000. Greenaway at ¶34.

RESPONSE: The United States objects to Paragraph 45 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 45 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because Thomas Greenaway lacks personal knowledge of the facts alleged in Paragraph 45. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that, on or about March 7, 2018, the Trustee filed a Form 1120X for TelexFree, LLC, for the tax year ending 2014; that the Form 1120X reported no tax due; and that the Form 1120X reported gross receipts of $2,067,416,945, and claimed deductions for "gross credit liability accrual" of $2,442,705,607 and for "165 loss SEC asset seizure" of $148,000,000. *See* U.S. S.O.F. ¶ 58.

46. A true and accurate copy of the 2014 Amended Return is annexed to the Greenaway Affidavit. Greenaway at ¶35.

RESPONSE: A true and accurate copy of the Form 1120X for the tax period ending December 31, 2014, is Exhibit 11 to the U.S. S.O.F. To the extent that Exhibit 5 to the Greenaway Affidavit is identical to Exhibit 11 to the U.S. S.O.F., it also is a true and accurate copy of the Form 1120X for the tax period ending December 31, 2014. To the extent that the Trustee seeks to rely on the Form 1120X for the tax period ending December 31, 2014, for the truth of any matters asserted therein, the document is inadmissible hearsay. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17.

47. On November 13, 2018, the Service issued an additional NOPA with respect to TelexFree, LLC's 2014 tax year, disallowing the casualty loss deduction of $148,000,000 claimed on the 2014 Amended Return. Greenaway at ¶36.

RESPONSE: The United States objects to Paragraph 47 because the facts alleged therein are irrelevant to this *de novo* proceeding. Subject to that objection, the United States admits the facts in Paragraph 47.

48. KPMG submitted a detailed response to the additional NOPA on or about December 3, 2018. Greenaway at ¶37.

RESPONSE: The United States objects to Paragraph 48 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 48 because the facts alleged therein are irrelevant to this *de novo* proceeding. Subject to those objections, the United States admits that, on or about December 3, 2018, Thomas Greenaway sent a letter to the IRS in response to the Notice of Proposed Adjustment described in Paragraph 47.

49. The Service's disallowance of the Promotional Expense deductions without any offsetting adjustment to the reported TelexFree income is fundamentally inconsistent with a fair presentation of TelexFree's taxable income or loss. Darr at ¶ 39; Greenaway at ¶ 38.

RESPONSE: The United States objects to Paragraph 49 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Subject to that objection, the United States denies Paragraph 49 because it contains legal conclusions and not undisputed facts. The Court will decide whether the Trustee has established that TelexFree is entitled to the claimed deductions. If the Court concludes, as the United States has argued, that the Trustee has not established TelexFree's entitlement to the claimed deductions, the Court then can decide whether it is necessary also to adjust TelexFree's income in order to determine its tax liability.

50. The Trustee has responded to all of the Service's requests for information both before and after the commencement of this litigation setting forth in detail the basis for each claimed deduction. The Trustee has answered the Service's request for production of documents, interrogatories and produced the Trustee for a deposition. The Trustee has also provided the Service with the Expert Report of Thomas Greenaway and produced Mr. Greenaway for a deposition by the Department of Justice. Darr at ¶ 50; Greenaway at ¶39.

RESPONSE: The United States objects to Paragraph 50 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States admits that the Trustee has responded to the IRS's requests for information, as well

as the United States' discovery requests, and that the Trustee provided the United States with an expert report from Thomas Greenaway and produced Thomas Greenaway for a deposition. The United States denies that the Trustee has adequately substantiated TelexFree's entitlement to the claimed deductions at issue in this motion. The Trustee has not responded with the necessary information.

Service's Actions Arbitrary

GENERAL RESPONSE: At the outset of this section, the United States notes that this is a *de novo* proceeding to determine TelexFree's tax liability in each of the tax years from 2012 through 2014. Contrary to the Trustee's counsel's implications, this is not an Administrative Procedures Act-style review of the IRS's decision-making process. The Trustee's use of the word "arbitrary" appears to be an attempt to shift the burden of proof based on Supreme Court precedent, but that precedent does not apply to tax assessments based on the disallowance of deductions. *See* U.S. Reply Brief, at 2-12. Taxpayers always have the burden of proving their entitlement to a deduction.

51. The Service's agents who made the determination to disallow the Promotional Expenses did so without any fundamental knowledge of TelexFree's business and how the Promotional Expenses were an integral part of the business. See Transcript of Deposition of Christine DeRosa, pg. 21 (hereinafter "DeRosa Transcript", annexed to Affidavit of Charles R. Bennett, Jr. as Exhibit 3).

RESPONSE: The United States objects that the facts in Paragraph 51 are irrelevant to this *de novo* proceeding. To the extent that the facts in Paragraph 51 assume that TelexFree was in the "trade or business" of either operating a Ponzi scheme or selling membership plans in a Ponzi scheme, the United States objects to those facts because the IRS disallowed TelexFree's claimed deductions for the promises it made to its victims based on TelexFree's representations in each of its returns—including all returns prepared and filed by the Trustee and KPMG, and signed by the Trustee under penalty of perjury—that TelexFree was in the "trade or business" of "DIRECT

SALES" of "COMMUNICATIONS" services. *See* Exhibit 3 to U.S. S.O.F. at 8, 21, 30; Exhibit 4 to U.S. S.O.F. at 3; Exhibit 5 to U.S. S.O.F. at 7; Exhibit 9 to U.S. S.O.F. at 62; Exhibit 11 to U.S. S.O.F. 8. The United States admits that the IRS disallowed TelexFree's claimed deductions based on the assumption that TelexFree was involved in direct sales of communications services, as the Trustee represented under penalty of perjury in each return. To the extent that the Trustee maintains that his representations under penalty of perjury in TelexFree's returns about the nature of its business activity were false, and that TelexFree was in the business of either operating a Ponzi scheme or selling membership plans in a Ponzi scheme, the United States admits that the IRS did not rely on the latter business activity in disallowing TelexFree's deductions.

52. The Service's agents had no prior experience on matters involving Ponzi and pyramid schemes. DeRosa Transcript, at pg. 27.

RESPONSE: The United States objects that the facts in Paragraph 52 are irrelevant to this *de novo* proceeding. Subject to that objection, the United States admits that the IRS Revenue Agent who examined TelexFree's returns had no prior experience with cases involving Ponzi and pyramid schemes.

53. The Service's agents had no knowledge of TelexFree's business. The Service's agents' investigation of the business was limited to Google searches. DeRosa Transcript, at pg. 22.

RESPONSE: The United States objects that the facts in Paragraph 53 are irrelevant to this *de novo* proceeding. The United States denies that the IRS Revenue Agent who examined TelexFree's returns had no knowledge of TelexFree's business: she had the information contained in TelexFree's returns, including the representation under penalty of perjury that TelexFree was in the business of direct sales of communications services; she also had the documents and information provided by Thomas Greenaway. Subject to those objections and

denials, the United States admits that the IRS Revenue Agent also performed one or more Google searches related to TelexFree.

54. The Service has no experts, no witnesses, and no evidence of an alternative compensation arrangement that would have achieved similar revenues for TelexFree.

RESPONSE: The United States objects that the phrase "an alternative compensation arrangement" is vague and ambiguous. The United States further objects that the facts in Paragraph 54 are irrelevant to this *de novo* proceeding. The United States objects to the extent Paragraph 54 is meant to imply that the United States has the burden to disprove TelexFree's entitlement to deductions, because the Trustee actually bears the burden to establish TelexFree's entitlement to its claimed deductions.

55. The only information the Service had regarding the relationship of the Promotional Expenses to TelexFree's business was provided by Thomas Greenaway of KPMG, the Trustee's expert. DeRosa Transcript, at pg. 30.

RESPONSE: The United States objects that the facts in Paragraph 55 are irrelevant to this *de novo* proceeding. Subject to that objection, the United States denies the facts in Paragraph 55. The IRS Revenue Agent who examined TelexFree's returns also had the returns under examination, which included representations by the Trustee under penalty of perjury that TelexFree was in the business of direct sales of communications services.

56. The Service understood that the Promotional Expenses promoted the Ponzi and pyramid scheme. DeRosa Transcript, at pg. 40.

RESPONSE: The United States objects that the facts in Paragraph 56 are irrelevant to this *de novo* proceeding. The United States further objects to the extent that the testimony of an IRS Revenue Agent's personal understanding is sought to be attributed to the IRS as a whole. Subject to those objections, the United States admits that the IRS Revenue Agent who examined the TelexFree returns understood that TelexFree's promises to its victims promoted the Ponzi and pyramid scheme.

57. The Service, further, understood the Promotional Expenses were to incentivize people to go out and bring more people into TelexFree, which was an essential part of any Ponzi and pyramid scheme. DeRosa Transcript, at pg. 41.

RESPONSE: The United States objects that the facts in Paragraph 57 are irrelevant to this *de novo* proceeding. The United States further objects to the extent that the testimony of an IRS Revenue Agent's personal understanding is sought to be attributed to the IRS as a whole. The United States objects to the phrase starting "which was an" and ending "pyramid scheme" because it is a characterization based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Subject to those objections, the United States admits that the IRS Revenue Agent who examined the TelexFree returns understood that TelexFree's promises to its victims were intended to incentivize its victims to recruit more victims into buying into the TelexFree scheme.

58. Notwithstanding having no personal knowledge of the business and how the Promotional Expenses fit into the TelexFree business, the Service determined that the Promotional Expenses were not ordinary and necessary because they only furthered the Ponzi and pyramid scheme. DeRosa Transcript, at pg. 44.

RESPONSE: The United States objects that the facts in Paragraph 58 are irrelevant to this *de novo* proceeding. The United States further objects to the extent that the testimony of an IRS Revenue Agent's personal understanding is sought to be attributed to the IRS as a whole. The United States objects to the phrase starting "Notwithstanding having no" and ending "the TelexFree business" because it is a characterization based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Subject to those objections, the United States admits that the IRS Revenue Agent who examined the TelexFree returns did so with the understanding, based on the Trustee's sworn statements in the returns, that TelexFree was in the business of direct sales of communications services, and that she determined that TelexFree's promises to its victims were not ordinary and necessary expenses of

such business activity. In addition, the IRS's determination that TelexFree's promises to pay its victims were not deductible under 26 U.S.C. § 162 formed one, but not the only, reason for the IRS's disallowance of the refund claim. *See* Exhibit 6 to U.S. S.O.F. (Doc. 54-6), at 4–5 (listing as additional reasons for disallowance the failure to adequately substantiate expenses, the failure to satisfy the requirements of 26 U.S.C. § 461, and the deduction of estimated amounts).

59. The Service did not consider the Promotional Expenses in the context of a Ponzi and pyramid scheme, but analogized them to the expenses incurred by different businesses. DeRosa Transcript, at pg. 44.

RESPONSE: The United States objects that the facts in Paragraph 59 are irrelevant to this *de novo* proceeding. The United States further objects to the extent that the testimony of an IRS Revenue Agent's personal understanding is sought to be extrapolated to the IRS as a whole. Subject to those objections, the United States admits that the IRS Revenue Agent who examined the TelexFree returns did so with the understanding, based on the Trustee's sworn statements in the returns, that TelexFree was in the business of direct sales of communications services; that she determined that TelexFree's promises to its victims were not ordinary and necessary expenses of such business activity; and that she reached that conclusion by analogizing to businesses other than Ponzi and pyramid schemes. In addition, the IRS's determination that TelexFree's promises to pay its victims were not deductible under 26 U.S.C. § 162 formed one, but not the only, reason for the IRS's disallowance of the refund claim. *See* Exhibit 6 to U.S. S.O.F. (Doc. 54-6), at 4–5 (listing as additional reasons for disallowance the failure to adequately substantiate expenses, the failure to satisfy the requirements of 26 U.S.C. § 461, and the deduction of estimated amounts).

60. Participants earned credits for promotional activities by logging onto TelexFree's website to download marketing materials, posting advertisements on the chosen websites, and returning to TelexFree's website to validate their posting of the advertisements, and by recruiting others to do so. Darr at ¶ 16.

RESPONSE: The United States objects to Paragraph 60 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 60. *See* Fed. R. Evid. 602.

61. TelexFree incurred a liability when it issued credits to Participants for posting advertisements on the internet in order to keep the TelexFree name before the public, to promote the goodwill of TelexFree, and to enlist new Participants. The advertising ensured TelexFree's name was frequently at the top of a listing of several MLM or business opportunities shown. Darr at ¶ 17.

RESPONSE: The United States objects to Paragraph 61 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 61. *See* Fed. R. Evid. 602.

62. TelexFree was almost exclusively an internet-based operation. TelexFree and its Participants promoted the business extensively using an online presence including internet advertisements, social media, and internet videos. Marketing meetings were also held to promote the business. Darr at ¶ 18.

RESPONSE: The United States objects to Paragraph 62 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 62. *See* Fed. R. Evid. 602.

63. Participants were separately incentivized to recruit others into TelexFree through the issuance of credits for selling memberships. Darr at ¶ 19.

RESPONSE: The United States objects to Paragraph 63 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 63. *See* Fed. R. Evid. 602.

64. TelexFree encouraged Participants to recruit new Participants into the business.

Darr at ¶ 20.

RESPONSE: The United States objects to Paragraph 64 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 64. *See* Fed. R. Evid. 602.

65. The promise of substantial returns was an essential element of the TelexFree business model. These credits were only to be issued upon the completion of the promotional activity. The right to earn credits for promoting TelexFree business was a primary inducement for Participants to join the TelexFree business. Darr at ¶ 21.

RESPONSE: The United States objects to Paragraph 65 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 65. *See* Fed. R. Evid. 602.

66. The Promotional Expense for advertising and selling membership plans represented a fixed and unconditional amount due to the Participant under the terms of his or her membership contract with TelexFree. Darr at ¶ 22.

RESPONSE: The United States objects to Paragraph 66 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 66. *See* Fed. R. Evid. 602. The United States objects to Paragraph 66 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99.

67. In the context of TelexFree's business, the Promotional Expenses were ordinary and necessary to the operation and expansion of the TelexFree business. Darr at ¶ 23.

RESPONSE: The United States objects to Paragraph 67 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 67. *See* Fed. R. Evid. 602. The United States objects to Paragraph 66 because it

improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99.

68. The amount of the Promotional Expenses represented a fixed and unconditional amount due to the Participant under the terms of his or her membership plan. Darr at ¶ 24.

RESPONSE: The United States objects to Paragraph 68 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 68. *See* Fed. R. Evid. 602. The United States objects to Paragraph 68 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99.

69. The Promotional Expenses incurred by TelexFree were normal, usual, and customary expenses associated with the development and operation of a Ponzi and pyramid scheme. Darr at ¶ 25.

RESPONSE: The United States objects to Paragraph 69 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 69. *See* Fed. R. Evid. 602. The United States objects to Paragraph 69 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99.

70. In the context of TelexFree's business, the Promotional Expenses were reasonable in amount and bore a reasonable relationship to the business of operating the TelexFree business. Darr at ¶ 26.

RESPONSE: The United States objects to Paragraph 70 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 70. *See* Fed. R. Evid. 602. The United States objects to Paragraph 70 because it improperly states a legal conclusion. *See Nieves-Villanueva*, 133 F.3d at 99.

71. The Promotional Expenses deducted on TelexFree's 2012 Amended Return, 2013 Amended Return, and 2014 Amended Return are substantiated by the books and records of TelexFree, including SIG. Darr at ¶ 27.

RESPONSE: The United States objects to Paragraph 71 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 71 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 71. *See* Fed. R. Evid. 602. The United States objects to Paragraph 71 because the returns are based on reconstructed financial data, and not the original books and records of TelexFree, as to which the Trustee cannot certify the completeness or the accuracy.

72. The Promotional Expenses were regularly redeemed by Participants until shortly before the Petition Date, both for cash and in satisfaction of membership fees due in connection with the purchase of membership plans in triangular transactions. Darr at ¶ 28.

RESPONSE: The United States objects to Paragraph 72 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 72. *See* Fed. R. Evid. 602.

73. The amount of Promotional Expenses redeemed by Participants approximated the amount of credits issued in each year. Darr at ¶ 29.

RESPONSE: The United States objects to Paragraph 73 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Paragraph 73 presents inadmissible "hearsay within hearsay." *See Patrick*, 248 F.3d at 22. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 73. *See* Fed. R. Evid. 602. The United States further objects to Paragraph 73 because it is based on reconstructed financial data, and not the original books and records of TelexFree, as to which the Trustee cannot certify the completeness or the accuracy.

74. Participants did not acquire an equity interest in TelexFree by entering into a membership contract with TelexFree. Darr at ¶ 30.

RESPONSE: The United States objects to Paragraph 74 because it is based on inadmissible

hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 74. *See* Fed. R. Evid. 602.

75. The Participants had no vote or input into management of TelexFree. Darr at ¶ 31.

RESPONSE: The United States objects to Paragraph 75 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 75. *See* Fed. R. Evid. 602.

76. The Participants were not employees of TelexFree. IRS Form 1099's were issued to Participants in the United States for the year ended 2013. Darr at ¶ 32.

RESPONSE: The United States objects to Paragraph 76 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 76. *See* Fed. R. Evid. 602.

Ympactus's Bad Debts

77. Ympactus operated in Brazil with a business model similar to the model employed by TelexFree. Darr at ¶ 33.

RESPONSE: The United States objects to Paragraph 77 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 77. *See* Fed. R. Evid. 602.

78. TelexFree provided accounting and administrative services to Ympactus in 2012 and 2013. Darr at ¶ 34.

RESPONSE: The United States objects to Paragraph 78 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The

United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 78. *See* Fed. R. Evid. 602.

79. In the 2012 Return and the 2012 Amended Return, TelexFree LLC and the Trustee, respectively, reported income from Ympactus in the amount of $11,869,444 as a charge to Ympactus for accounting and administrative services provided by TelexFree to Ympactus. Darr at ¶ 35; Greenaway at ¶ 40.

RESPONSE: The United States objects to Paragraph 79 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee and Thomas Greenaway lack personal knowledge of the facts alleged in Paragraph 79. *See* Fed. R. Evid. 602. The United States objects to Paragraph 79 because it is based on reconstructed financial data, and not the original books and records of TelexFree, as to which the Trustee and Thomas Greenaway cannot certify the completeness or the accuracy.

80. In the 2013 Return and 2013 Amended Return, the Trustee on behalf of TelexFree LLC reported income from Ympactus in the amount of $174,183,645 as a charge to Ympactus for accounting and administrative services provided by TelexFree to Ympactus. Darr at ¶ 36; Greenaway at ¶ 41.

RESPONSE: The United States objects to Paragraph 80 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee and Thomas Greenaway lack personal knowledge of the facts alleged in Paragraph 80. *See* Fed. R. Evid. 602. The United States further objects to Paragraph 80 because it is based on reconstructed financial data, and not the original books and records of TelexFree, as to which the Trustee and Thomas Greenaway cannot certify the completeness or the accuracy.

81. In 2013, the Brazilian authorities seized all of Ympactus' assets and its operations ceased, and its obligations to TelexFree became uncollectible. Darr at ¶ 37.

RESPONSE: The United States objects to Paragraph 81 because it is based on inadmissible

hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 81. *See* Fed. R. Evid. 602.

82. In both the 2013 Return and 2013 Amended Return, TelexFree LLC and the Trustee recognized the uncollectibility of the unpaid amounts due from Ympactus in the amount of $186,344,898 because of the Brazilian authorities seizure of Ympactus' operations and all of its assets that year. Darr at ¶ 38; Greenaway at ¶ 42.

RESPONSE: The United States objects to Paragraph 82 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee and Thomas Greenaway lack personal knowledge of the facts alleged in Paragraph 82. *See* Fed. R. Evid. 602. The United States objects to Paragraph 82 because it is based on reconstructed financial data, and not the original books and records of TelexFree, as to which the Trustee and Thomas Greenaway cannot certify the completeness or the accuracy.

83. The Service's disallowance of the Ympactus bad debt deduction without any offsetting adjustment to the reported Ympactus income is fundamentally inconsistent with a fair presentation of TelexFree's taxable income or loss. Darr at ¶ 39; Greenaway at ¶ 43.

RESPONSE: The United States objects because the Trustee and Thomas Greenaway lack personal knowledge of the facts alleged in Paragraph 83. *See* Fed. R. Evid. 602. Subject to that objection, the United States denies Paragraph 83 because it contains legal conclusions and not undisputed facts. The Court will decide whether the Trustee has established that TelexFree is entitled to the claimed deductions. If the Court concludes, as the United States has argued, that the Trustee has not established TelexFree's entitlement to the claimed deductions, the Court then can decide whether it is necessary also to adjust TelexFree's income in order to determine its tax liability.

Casualty Loss

84. On April 15, 2014, federal agents executed three search warrants at TelexFree headquarters in Marlborough, Massachusetts. During that search, federal officers seized TelexFree's property including but not limited to cashiers' checks totaling approximately $38,000,000. Subsequently, the U.S. Attorney's Office for the District of Massachusetts executed 37 additional seizure warrants. The United States ultimately seized in excess of $148,000,000 in cash and real and personal property in proceeds from the operation of the TelexFree business (the "Funds"). Darr at ¶ 40.

RESPONSE: The United States objects to Paragraph 84 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 84. *See* Fed. R. Evid. 602.

85. On or about July 23, 2014, a grand jury sitting in the District of Massachusetts returned an indictment against James Merrill ("Merrill") and Carlos Wanzeler in a case styled as United States v. James Matthew Merrill, et al., 4:14-cr-40028-TSH, in the United States District Court for the District of Massachusetts, based on their involvement in Debtors' illegal conduct (the "Indictment").

RESPONSE: The United States admits the facts in Paragraph 85.

86. On or about September 8, 2016, a grand jury sitting in the District of Massachusetts returned a seventeen-count superseding indictment against Merrill and Carlos Wanzeler in a case styled as United States v. James Matthew Merrill, et al., 4:14-cr-40028-TSH, in the United States District Court for the District of Massachusetts, based on their involvement in Debtors' illegal conduct (the "First Superseding Indictment").

RESPONSE: The United States admits the facts in Paragraph 86.

87. On March 22, 2017, the District Court entered a preliminary order of forfeiture finding that, among other assets, the Funds are forfeited to the United States [docket entry 347] (the "Preliminary Order of Forfeiture").

RESPONSE: The United States admits that, on March 22, 2017, the District Court entered a Preliminary Order of Forfeiture (Doc. 347 in *United States v. Merrill*, Case No. 4:14-cr-40028-TSH (D. Mass.)), in which the Court found that the prerequisites to forfeiture had been established and authorized the United States to seize the "Forfeitable Assets," a list of which was included as Exhibit 1 to the order. The United States contends that the Trustee has not established that TelexFree owned all of the forfeited assets. Many of the forfeited assets were in

the name of persons or entities other than TelexFree, or else the Court's order did not specify the owner of the assets. *See* Doc. 347 in *United States v. Merrill*, at 7–13.

88. No criminal fines or penalties have been imposed upon TelexFree. Darr at ¶ 41.

RESPONSE: The United States objects to Paragraph 88 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 88 because the facts contained therein are irrelevant.

89. The Trustee has worked closely with the United States in connection with the recovery of funds to be paid as restitution for victims. Darr at ¶ 42.

RESPONSE: The United States objects to Paragraph 89 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects to Paragraph 89 because the facts contained therein are irrelevant.

90. The Trustee had notice of the Preliminary Order of Forfeiture and did not object or challenge the order of forfeiture with respect to the Funds and tangible property as part of an agreement with the United States that the Funds and tangible property, or proceeds thereof, would be turned over to the Trustee for payment as restitution to victims. Darr at ¶ 43.

RESPONSE: The United States objects to Paragraph 90 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. Subject to that objection, the United States admits that the Trustee did not object to or challenge the preliminary order of forfeiture.

91. On July 11, 2017, in connection with the sentencing of James Merrill for his participation in TelexFree, the District Court entered an order authorizing the Trustee to establish a system to administer restitution claims and pay restitution to victims, and ordered restitution to be paid to the victims of TelexFree by the Trustee [Docket No. 367] (the "Restitution Order").

RESPONSE: The United States admits that, on July 11, 2017, the District Court entered a Restitution Order (Doc. 367 in *United States v. Merrill*, Case No. 4:14-cr-40028-TSH (D. Mass.)), in which the Court authorized the Trustee, as opposed to the Clerk's Office, to pay restitution *pro rata* to the TelexFree victims, with the meaning of the term "victim" defined in

the Restitution Order.

92. The Restitution Order was premised upon the agreement between the United States and the Trustee that the seized funds would be delivered to the Trustee to be administered by the Trustee as restitution for the benefit of the victims of the Ponzi scheme. Darr at ¶ 45.

RESPONSE: The United States objects to Paragraph 92 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17.

93. On June 14, 2018, the District Court ordered that the Funds be turned over to the Trustee [Docket No. 398] so that the Funds may be applied toward restitution consistent with the terms of the Restitution Order.

RESPONSE: The United States admits that, on June 14, 2018, in an Order To Apply Certain Assets to Restitution (Doc. 398 in *United States v. Merrill*, Case No. 4:14-cr-40028-TSH (D. Mass.), the District Court granted the United States' motion to apply certain forfeited assets to restitution, and authorized the United States to turn over the forfeited assets to the Clerk of Court or the Trustee (as directed by the Clerk) for application to restitution.

94. On or about June 15, 2019, the United States turned over to the Trustee the sum of $145,471,294 in connection with the Restitution Order. Darr, at¶ 46.

RESPONSE: The United States objects to Paragraph 94 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17.

95. On June 14, 2018, the District Court ordered that the tangible property be forfeited and that the United States was authorized to deliver the property or its proceeds to the Trustee for distributions to victims. [Docket No. 400]

RESPONSE: The United States admits that, on June 14, 2018, the District Court entered a Partial Final Order of Forfeiture (Doc. 400 in *United States v. Merrill*, Case No. 4:14-cr-40028-TSH (D. Mass.)) in which the Court forfeited to the United States: (1) a cashier's check payable to Carlos Wanzeler; (2) 24 real properties described by address and book and page number; (3) all right, title, and interest in three notes and mortgages, two held by Acceris Realty Estate LLC, and one held by Above & Beyond the Limit, LLC; and, (4) all funds on deposit in two bank

accounts held in the name of Carlos Wanzeler. In that order, the District Court authorized the Department of Homeland Security to dispose of the forfeited assets in accordance with law, including allowing the Trustee to dispose of the assets.

96. The action by the United States Trustee in seizing property of TelexFree or property derived from or constituting proceeds traceable to the business of TelexFree is a loss of property (the "Loss") for TelexFree. Darr at ¶ 47.

RESPONSE: The United States objects to Paragraph 96 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 96. *See* Fed. R. Evid. 602. The United States objects to Paragraph 96 because it improperly states a legal conclusion. Subject to those objections, the United States denies Paragraph 96.

97. TelexFree was not insured for the Loss nor otherwise compensated for the Loss. Darr at ¶ 48.

RESPONSE: The United States objects to Paragraph 97 because it is based on inadmissible hearsay, not admissible evidence. *See* Fed. R. Evid. 801(c), 802; *Davila*, 498 F.3d at 17. The United States further objects because the Trustee lacks personal knowledge of the facts alleged in Paragraph 97. *See* Fed. R. Evid. 602. Subject to those objections, the United States admits that TelexFree was not insured for any loss described above in Paragraph 96. The United States denies that TelexFree was not "otherwise compensated" for any loss, however, because the Trustee has stated that TelexFree has recovered $145,471,294 from the forfeited assets.

98. The Trustee has displaced the Debtors' management, and operations have been shut down. The Trustee was appointed to liquidate the Debtors' assets and to pursue recoveries. Darr at ¶ 49.

RESPONSE: The United States admits the facts in Paragraph 98.

99. Many income-producing businesses that engage in illegal activity under federal and/or state law are permitted to take deductions for expenses incurred in pursuing the business. Greenaway at ¶ 44.

RESPONSE: The United States objects that Paragraph 99 improperly states a legal conclusion. Subject to that objection, the United States admits that many profit-motivated businesses that engage in illegal activity under federal and / or state law are eligible to take deductions for expenses incurred in pursuing the business.

100. The Parties agree that the Court may take judicial notice of the papers and Orders entered in the cases of United States of America v. James Merrill, 4:14-CR-40028-TSH, Securities & Exchange Commission v. TelexFree, Inc. et al, 1.14 CV 11858 DJC, and In re TelexFree, LLC et al, case no. 14-40987 as jointly administered.

RESPONSE: The United States agrees that the Court may take judicial notice of events and orders in the cases listed in Paragraph 100.

Respectfully submitted,

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

/s/ Lauren E. Hume
LAUREN E. HUME
Trial Attorney, Tax Division
U.S. Department of Justice
P.O. Box 55
Washington, D.C. 20044
202-307-2279 (v)
202-514-5238 (f)
Lauren.E.Hume@usdoj.gov