Docket #0082 Date Filed: 12/16/2019

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS

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

SURREPLY BY CHAPTER 11 TRUSTEE TO UNITED STATES OF AMERICA'S SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT

Stephen B. Darr, the Chapter 11 Trustee ("Trustee") of the bankruptcy estates ("Estates") of TelexFree LLC, TelexFree Inc., and TelexFree Financial Inc. (collectively, "TelexFree") respectfully submits this Surreply in opposition to the Second Motion by the United States of America (the "Service") for Partial Summary Judgment on Counts I, II, and III of the Complaint.[1]

[1] The Trustee incorporates by reference its prior Opposition [Doc. No. 65] concerning the issues not expressly discussed herein, and 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* ("SUF").

I. The Trustee's SUF complies with the Local Rules, is based on personal knowledge, and does not rely on inadmissible hearsay.

Fed. R. Civ. P. 56(c) provides that both parties may assert "that a fact cannot be or is genuinely disputed" for summary judgment purposes. Local Rule 56.1 states, in relevant part: "A party opposing the motion shall 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, with page references to affidavits, depositions and other documentation." There are no specific restrictions as to the form or caption of such a statement. The Trustee's SUF, which is supported by affidavits and exhibits, satisfies the Rules' purpose of narrowing factual disputes while providing the Court with a more complete record upon which to determine summary judgment pursuant to Rule 56(f). The Service has provided no supporting authority for the extraordinary request to strike the Trustee's SUF, to which the Service has already submitted an itemized Response.

Courts routinely reject the type of evidentiary objections advanced by the Service based on hearsay and lack of personal knowledge, including in the Ponzi context. In *Curtis v. Perkins*, 781 F.3d 1262 (11th Cir. 2015), the Eleventh Circuit affirmed the bankruptcy court's admission of summaries prepared by the bankruptcy trustee to establish the debtor's financial condition at an evidentiary hearing to determine that the debtor was operating a Ponzi scheme. The Eleventh Circuit held that the summaries were admissible under the hearsay exception for "business records" because the trustee's testimony established: 1) a prima facie case that the underlying documents were authentic, a "light" burden; and 2) that the requirements of Fed. R. Evid. 803(6) were met.[2] *Id*. at 1266-67. The trustee may rely on circumstantial evidence, including his own testimony that is based on hearsay; and "the testifying witness does not need firsthand

[2] These requirements are: whether the subject document "was made at or near the time by — or from information transmitted by — someone with knowledge"; if it "was kept in the course of a regularly conducted activity"; and if "making the record was a regular practice of that activity." *Id*. at 1267 (quoting Fed. R. Evid. 803(6)(A)-(C)).

knowledge of the contents of the records, of their authors, or even of their preparation." *Id*. at 1268 ("As long as the trustee presented enough circumstantial evidence to establish the trustworthiness of the underlying documents, he did not need to present testimony from the person who actually prepared them; his own testimony would suffice.").

Here, as in *Curtis*, the Trustee's custodial and reconstruction methodology is extensively detailed in the record. Accordingly, the Court should overrule the Service's objections, for which it provides no relevant supporting authority. *Compare id*. at 1265, 1267-68 (trustee's admissible circumstantial evidence included his own testimony concerning his custodianship over the underlying documents, his efforts to "reconstruct" the records with his experience as a certified fraud examiner, and his work with the FBI and SEC and engagement of third parties to cross-reference information from other sources). *See also Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Madoff)*, 592 B.R. 513, 524-29 (Bankr. S.D.N.Y. 2018) (Ponzi case with similar analysis and holdings, admitting testimony by trustee and experts concerning reconstructed records and their reliability to establish business record exception). *See also* Fed. R. Evid. 807 (providing for admission of hearsay so long as the statement is 1) "supported by sufficient guarantees of trustworthiness" considering the totality of circumstances, and 2) "more probative on the point for which it is offered than any other evidence that the proponent can obtain through reasonable efforts.").

II. The Service bears the burden of proof as to all issues pursuant to 26 U.S.C. § 7491(a).

Section 7491(a) provides, in relevant part: "[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) (emphasis added). The Service incorrectly cites *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992) for the unsupported premise that "the ultimate burden of

proof with respect to deductions" does not shift. *INDOPCO* was decided before Section 7491(a) was codified (1998), and naturally does not discuss the statute or its burden-shifting implications. The Service also incorrectly frames the issues before the Court as solely questions of law (Reply, pp. 3-4), whereas these issues, including most importantly whether TelexFree operated as a trade or business, are actually questions of fact or mixed questions of law and fact, which themselves require further factual inquiries. *See Commissioner v. Groetzinger*, 480 U.S. 23, 36 (1987). The burden shifts to the Service as to each issue before the Court because the Trustee has established that 7491(a)(2)'s compliance requirements are met and has provided relevant credible evidence.

With respect to the compliance requirements, the Service challenges only the sufficiency of the maintenance of records,[3] relying on the same hearsay and personal knowledge objections that were refuted above. The Service has provided no relevant supporting authority of its own.[4] The Service relies on the same fallacious objections as the basis for challenging the credible evidence presented by the Trustee in the SUF and supporting documents, which include the affidavits of the Trustee and the Trustee's expert, Thomas Greenaway, tax returns, and other documents provided by the Trustee to the IRS. Given that the SUF and associated documents are admissible, there can be no legitimate dispute that they constitute credible evidence as to each issue before the Court.[5] The Service itself intrinsically acknowledges both that the relevant records were sufficiently maintained and that credible evidence has been presented, given that it

[3] The taxpayer must demonstrate that it kept "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 in any return of such tax or information." 26 C.F.R. § 1.6001-1(a); 26 U.S.C. § 6001.

[4] Similarly, to the extent that the Service argues—also without supporting authority—that the Trustee cannot act as the taxpayer for Section 7491 purposes, "[t]his argument is without merit." *In re Industrial Commercial Electrical Inc.*, 319 B.R. 35, 53 (2005) ("There can thus be little doubt that a trustee or debtor in possession, acting on the estate's behalf, could invoke 26 U.S.C. § 7491.").

[5] "Credible evidence" is "the quality of 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…, if after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof." H. Conf. Rept. 105-599, at 240-41 (1998), 1998-3 C.B. 747, 994-95.

accepts the annual gross income figures provided for TelexFree, which were generated from the same underlying records.

Imposing the Service's unreasonably high standards for burden shifting under these circumstances would swallow the statutory exception, which was intended 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 IRS with all information relevant to the determination of their tax liabilities. *See* S. Rep. No. 105-174, at 44 (1998).

III. The record establishes that the Promotional Expenses are deductible.

A taxpayer qualifies as being engaged in a "trade or business" when it is "involved in the activity with continuity and regularity" and "the taxpayer's primary purpose for engaging in the activity must be for income or profit."[6] *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) (emphasis added). The taxpayer "need not have a reasonable expectation of a profit," so long as the taxpayer "initiate[s] or conduct[s] the enterprise in good faith with an intention of making a profit or of producing income. *Int'l Trading Co. v. Commissioner*, 275 F.2d 578, 584 (7th Cir. 1960) (emphasis added).[7]

In *Int'l Trading*, the Seventh Circuit explained that "the profit factor is really only significant in so far as it affords a means of distinguishing between an enterprise carried on in good faith as a 'trade or business' and an enterprise merely carried on as a hobby." *Id*. (emphasis added; citation omitted); *accord Groetzinger*, 480 U.S. at 35 ("A sporadic activity, a hobby, or an amusement diversion does not qualify."). The allowance of deductions for expenses associated with producing income is consistent with the "fundamental principle of taxation: that

[6] There is no dispute that TelexFree was engaged in the sale of membership plans "with continuity and regularity."
[7] "Good faith" does not require that the taxpayer must have intended to produce the income by honest means. *See Commissioner v. Heininger*, 320 U.S. 467 (1943) (purpose of tax law is not to penalize illegal businesses by taxing gross income rather than net income).

a person's taxable income should not include the cost of producing that income." *Hantzis v. Commissioner*, 638 F.2d 248, 249 (1st Cir. 1981).

The determination of whether a taxpayer is carrying on a trade or business "requires an examination of the facts in each case," and the U.S. Supreme Court has cautioned "that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code." *Groetzinger*, 480 U.S. at 36. Here, while conceding that it cannot cite to any supporting authority (Reply, p. 15), the Service requests that the Court impose just such an overbroad judicial rule finding that an enterprise that engages in a Ponzi scheme *per se* cannot qualify as a trade or business. As in *Groetzinger*, rather than deferring to the Service's position, the Court should "defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business" based on the specific facts and circumstances. *Id*. at 35.

The Service concedes that a corporation is entitled to a presumption of being engaged in a trade or business (Reply, p. 13). *See Int'l Trading*, 275 F.2d at 584 ("A corporation is normally deemed to be engaged in a 'trade or business'" except "to the extent that it is operated solely for the pleasure or recreation of its stockholders"). The undisputed facts in the record establish that TelexFree unquestionably operated its business to generate income or profit, rather than for pleasure or recreation. *See* Opp., pp. 8-9. TelexFree conducted its business on a full-time basis, engaging multiple employees, renting office space, contracting with vendors, and interacting with Participants. SUF, ¶¶ 13, 14. While TelexFree's stated business was the sale of VoIP services, the undisputed record establishes that its actual business was a Ponzi/pyramid scheme that relied on the sale of membership plans. TelexFree's primary purpose was to generate income from the sale of membership plans to recruited Participants, who would themselves recruit others, thereby generating more income for the corporation.

TelexFree maintained records which show that it generated substantial gross income in each year of operation: $18,220,915 in 2012; $1,173,886,556 in 2013; and $2,067,416,945 in 2014. SUF, ¶¶ 31, 45. Furthermore, TelexFree in fact had a profit in its first year of operation in 2012. TelexFree's original tax return for 2012 reported a profit and income taxes of $686,121. TelexFree paid to the Service $686,121 in taxes and an additional $200,579 in penalties and interest for 2012. The Second Amended Return filed by the Trustee continued to report a profit for 2012, but requested a refund of amounts paid for that year on account of carry-back losses from subsequent years. SUF, ¶¶ 27-31; *see* Opp., pp. 8-9 & n.5.

The Service has not specified any facts in the record establishing that the enterprise was "merely carried on as a hobby" or for personal recreation to overcome the corporate presumption. *Contrast Int'l Trading*, 275 F.2d at 582 (where taxpayer's general business was being a brewery supplier, the court rejected deductions of expenses associated with maintaining property that "was held primarily for the personal use of the taxpayer's stockholders").

Similarly, the Service has failed to identify any facts in the record to demonstrate that TelexFree was merely a sham tax shelter, as in *Kelley v. Comm'r*, T.C. Memo. 1993-495, a distinguishable non-binding Tax Court case cited in the Service's Reply. *Kelley* is one of a long line of tax shelter cases standing for the unremarkable principle that entities formed and operated solely for tax avoidance purposes will be disregarded for tax purposes. The Tax Court in *Kelley* disallowed the taxpayer-partnership from deducting certain expenses because the primary purpose of the coal programs at issue was to provide investors with tax benefits. Contrary to the Service's representations, *Kelley* did not hold that a Ponzi scheme cannot qualify as a trade or business; in fact, the Ponzi aspect of the enterprise, mentioned solely as *dicta*, was not at issue in the decision. To the extent that the Service argues, without supporting facts, that TelexFree operated as a sham for the sole benefit of its owners, its position is inherently contradictory

because, in that case, the Service should not be seeking to tax TelexFree's income at the entity level. *See e.g., Full-Circle Staffing, LLC v. Commissioner*, T.C. Memo. 2018-66 (sham partnerships' income properly taxable to their ultimate owner). Common sense dictates that TelexFree was operated as a trade or business.

The Service's inconsistent position runs afoul of the IRC's guiding principle of taxing net income rather than gross receipts. The Service has filed administrative and priority claims against the Estates in the aggregate amount of more than $400,000,000 based on TelexFree's reported income of $3,000,000,000 while disallowing virtually all deductions for corresponding accrued expenses. SUF, ¶¶ 40, 42. There can be no legitimate dispute that the Promotional Expenses were incurred directly in connection with, and were integral to, TelexFree's generation of income. These Promotional Expenses were the primary incentive motivating Participants to purchase membership plans and recruit new Participants. *See* Opp., pp. 12-13 (discussing critical role of Promotional Expenses in growing sales of membership plans).

If the Court were to agree with the Service's position, the result would be "distinctly out of line with the Code's focus on income." *Groetzinger*, 480 U.S. at 35. Indeed, as the U.S. Supreme Court stated in *Commissioner v. Sullivan*, 356 U.S. 27, 29 (1958): "If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income." Tellingly, the Service acknowledges the inconsistency of its own position in its Response to SUF, ¶ 49, which states in relevant part:

> 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.

(emphasis added). Based on the undisputed record, the Court should conclude that the Promotional Expenses are deductible, which obviates any need to make further adjustments to income.

Thus, while the Service concedes, as it must, that an illegal enterprise may be operated as a trade or business that is entitled to deduct expenses (Reply, p. 15), it is nevertheless seeking to punish or otherwise treat TelexFree differently by seeking to tax accrued income without allowing corresponding deductions for accrued Promotional Expenses. The Service's position is untenable. *See Commissioner v. Tellier*, 383 U.S. 687, 691 (1966) ("the federal income tax is a tax on net income, not a sanction against wrongdoing… Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources.").

Given the undisputed facts in the record, "basic concepts of fairness (if there be much of that in the income tax law) demand that [TelexFree's] activity be regarded as a trade or business just as any other readily accepted activity." *Groetzinger*, 480 U.S. at 33. Accordingly, the Court should determine that the Promotional Expenses are deductible.

CONCLUSION

The Service has failed to meet its burden of proof that the deductions claimed by the Trustee should be disallowed. The undisputed facts in the record establish that the Trustee is entitled to summary judgment pursuant to Fed. R. Civ. P. 56(f). Accordingly, the Court should deny the Service's motion for summary judgment and enter judgment for the Trustee on Counts I, II, and III of the Complaint.

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

Dated: December 12, 2019

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CERTIFICATE OF SERVICE

I certify that this document, filed through the ECF system on December 12, 2019, will be sent electronically to the registered participants as identified on the Notice of Electronic Filing (NEF).

/s/ Harold B. Murphy
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