Internal Revenue Service

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Person To Contact:
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Date:
July 11, 2012

TY:

LEGEND:

Taxpayer A:

Taxpayer B:

Taxpayers: Taxpayer A and Taxpayer B

Minority Owner C:

Minority Owner D:

Insurance Company:

Government Entity E:

Government Entity F:

Practice Entity G:

Practice Entity H:

$J:

$K:

$L:

$M:

$N:

$P:

$Q:

$R:

$S:

$T:

$U:

$V:

$W:

$X:

$Y:

$Z:

AA%:

BB%:

CC%:

DD%:

EE%:

FF%:

GG%:

Year 1:

Year 2:

Year 3:

Year 4:

Year 5:

Year 6:

Year 7:

Year 8:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

Date 7:

Date 8:

Date 9:

Date 10:

Dear :

This is in response to the letter sent by your attorneys dated Date 1. In the letter, your attorneys requested that the IRS rule that (1) the $K Taxpayer B paid to the Insurance Company in Year 4 will be deductible as a loss incurred in a trade or business under section 165(c)(1) of the Internal Revenue Code ("Code") in the year paid, and that (2) Taxpayer B will be able to deduct the $L due to Government Entity E and Government Entity F in the tax years in which the installment payments are made under the settlement agreement ($M paid to Government Entity E and Government Entity F in Year 4, the $N paid in Year 5, and the $P due in Year 6, $P due in Year 7, and the $Q due in Year 8 provided those amounts are paid in the years in which they are due).

FACTS

The Taxpayers are physicians who practiced medicine under several professional entities, including Practice Entity G and Practice Entity H. When Practice Entity G, a limited liability company, was formed on Date 2, Taxpayer A owned AA% and Minority Owner C owned BB% of Practice Entity G. At some point later not specified in the Taxpayers' submission, Taxpayer B became a member of Practice Entity G with a CC% ownership interest. Taxpayer A's ownership fell to CC% and Minority Owner C continued to own BB%. Taxpayers currently practice under Practice Entity H. When Practice Entity H, also a limited liability company, was formed on Date 3, Taxpayer A owned DD% of Practice Entity H, Taxpayer B owned EE% and Minority Owner D owned FF%. Minority Owner D subsequently left the practice. After Minority Owner D's departure until Date 4, Taxpayer A owned FF% and Taxpayer B owned GG% of Practice Entity H. On Date 5, Taxpayer B became an employee of Practice Entity H and thus Taxpayer A came into ownership of 100% of Practice Entity H.

In Year 1, the Insurance Company sued the Taxpayers, Minority Owner C, and Practice Entities A and B for insurance fraud, demanding both compensatory and punitive damages. On Date 6, the parties entered into a settlement agreement in which the defendants agreed to pay $J by Date 7 and $R in monthly installments of $S beginning on Date 8. Included in the $J was $T of unpaid legitimate bills for patient services due to Practice Entity G (at that point entirely owned by Taxpayer A) that the Insurance Company was refusing to pay until the parties settled the litigation. In exchange for the payment, the Insurance Company agreed to release its claim for restitution in a then pending criminal action. The agreement stated that each defendant "shall be individually responsible for any and all payments due under this Agreement." Taxpayer A paid the balance of the $J less the $T to the Insurance Company in Year 3. In Year 4, Taxpayer A and Taxpayer B each paid $K to the Insurance Company, equal to the $R due under the settlement agreement. Minority Owners C and D paid no amounts due under the settlement agreement.

In addition to the suit the Insurance Company filed, the state of New Jersey indicted Taxpayer B, Practice Entity E, and Practice Entity E's former office manager for insurance fraud in Year 2. On Date 9, the LLC entered into a plea agreement and paid a $U fine. Seven days later, Taxpayer B agreed to pay $L in restitution to Government Entity E and Government Entity F over four years (Year 4 through Year 8) in exchange for dismissal of the charges against him. The consent agreement, entitled "Consent Order for Restitution", allotted $V to Government Entity E and $W to Government Entity F. Taxpayer B paid $X upon signing the agreement, paid another $X within six months of the execution date, and agreed to pay the remaining $Y at a rate of $Z per month beginning on Date 10 until the $Y liability is paid off. The court's records for Practice Entity F's guilty plea state only that Taxpayer B "has agreed to make restitution in the amount of [$L] as a condition of dismissal of his charges" and that "the citizens of New

Jersey and the United States will recognize significant recoupment of the ill-gotten billings of the Company."

Taxpayer B has represented (a) that he previously included in his gross income in prior tax years the amounts he now seeks to deduct and (b) that he and all other defendants in [both] lawsuits are jointly and severally liable for the amounts due under the settlement agreement because the language of the settlement agreement imposes joint liability upon the defendants and New Jersey law imposes joint and several liability upon members of a limited liability company.

LAW AND ANALYSIS

Deductions are a matter of legislative grace and a taxpayer must satisfy the specific statutory requirements of the deductions claimed. Indopco, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Deputy v. du Pont, 308 U.S. 488 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). Taxpayers bear the burden of proving entitlement to the deductions they claim. Welch v. Helvering, 290 U.S. 111 (1933).

Section 162(a) of the Code and section 1.162-1(a) of the Income Tax Regulations ("regulations") allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(f) states that no deduction shall be allowed under section 162 for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(b)(1)(iii) of the regulations states that for purposes of section 162 a fine or similar penalty includes an amount paid in settlement of a taxpayer's actual or potential liability for a fine or penalty (civil or criminal). Section 1.162-21(b)(2) of the regulations states that compensatory damages paid to a government do not constitute a fine or penalty.

Section 165 states that taxpayers may deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise. In the case of an individual, the deduction under section 165 is limited to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from casualty or theft.

The repayment of fraudulently obtained funds is not deductible under section 165(c)(1). Kraft v. United States, 991 F.2d 292, 298 (6th Cir. 1993); Mannette v. Commissioner, 69 T.C. 990, 992 (1978); Wusich v. Commissioner, 35 T.C. 279, 287 (1960). Accordingly, the Taxpayers are not entitled to a deduction under section 165(c)(1) for the restitution they paid to the Insurance Company. However, Taxpayers that repay embezzled funds are ordinarily entitled to a deduction under section 165(c)(2) in the year in which the funds are repaid. Stephens v. Commissioner, 905 F.2d 667 (2nd Cir. 1990). Rev. Rul. 65-254, 1965-2 C.B. 50, holds that a deduction is allowable under section 165 with

respect to the repayment of embezzled funds by the embezzler for the taxable year in which the repayment is made. A similar result was reached in Rev. Rul. 82-74, 1982-1 C.B. 110, which holds that a convicted arsonist is entitled to a loss deduction under section 165 for repayment to an insurance company for restitution in the taxable year of repayment to the extent the proceeds were previously included in gross income. In short, payments in the nature of restitution are deductible under section 165(c)(2).

Loss deductions claimed under section 165 are not allowed where "the allowance of a deduction would frustrate sharply defined national or state policies proscribing particular types of conduct." Commissioner v. Tellier, 383 U.S. 687, 694 (1966) (quoting Commissioner v. Heininger, 320 U.S. 467, 473 (1943)). The public policy doctrine disallowing a deduction under section 165 precedes the codification of the public policy doctrine in section 162 in the form of sections 162(c), (f) and (g), which were enacted in 1969. See section 902, Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, 710. Therefore, the disallowance of deductions under section 165 based on public policy is not limited to the type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder. Rev. Rul. 77-126, 1977-1 C.B. 47; Stephens v. Commissioner, supra; see also Cavaretta v. Commissioner, T.C. Memo. 2010-4; Rev. Rul. 81-24, 1981-1 C.B. 79; Rev. Rul. 82-74, 1982-1 C.B. 110. The reach of the public policy exception under section 165 is at least co-extensive (see Ginsburg v. Commissioner, T.C. Memo. 1994-272) if not broader than the reach of section 162(f).

Courts will typically give effect to the express tax characterization of a settlement payment by the parties to a settlement agreement. Thus, the parties' characterization of the payment, rather than the character of the original claims to which the settlement payment relates, determines the deductibility of such payments. Middle Atlantic Distributors Inc. v. Commissioner, 72 T.C. 1136, 1145 (1979), acq. 1980-1 C.B. 1; Grossman & Sons, Inc., 48 T.C. 15, 29 (1967); Rev. Rul. 80-334, 1980-2 C.B. 61.

Taxpayer B has represented that under New Jersey law, members of a limited liability company are jointly and severally liable for the payment of damages awarded in civil suits. The Insurance Company released its claim for restitution in the criminal suit in exchange for the Taxpayers' settlement payment. Thus, the settlement payment was restitution. As stated above, payments for restitution are deductible under section 165(c)(2). Therefore, Taxpayer B may deduct the portions of the damage award he actually paid to the Insurance Company as losses under section 165(c)(2) provided he received no contribution from any other party and included the amounts in his gross income in prior tax years. See Rev. Rul. 82-74, 1982-1 C.B. 110. Neither section 162(f) nor the public policy doctrine of section 165 are implicated with respect to the payments made to the Insurance Company.

The payments Taxpayer B made to Government Entity E and Government Entity F raise the possible application of section 162(f) and the public policy doctrine of section 165. The terms of the settlement agreement and the court's records do not clearly indicate

whether the payments were intended as compensation to a governmental entity, rather than as a fine or penalty. The settlement agreement and the court's records use the term "restitution" but the fact that a payment is denominated as "restitution" does not necessarily qualify it as a restitution payment deductible under section165(c)(2). For example, a deduction is not necessarily permitted where the payments are made in satisfaction of criminal liability to a state even if the payments are described as restitution. Kraft v. United States, 991 F.2d 292 (6th Cir. 1993); Waldman v. Commissioner, 88 T.C. 1384 (1987), aff'd 850 F.2d 611 (9th Cir. 1988); see also Bailey v. Commissioner, 756 F.2d 44 (6th Cir. 1985) (where a restitution payment connected with a sentence was disallowed as a deduction even though the taxpayer's fine was applied as restitution in a settlement of a multidistrict class action then pending against the taxpayer's corporation and its officers). In Waldman, the court noted that where a payment serves both a law enforcement function and a compensatory function it must be determined which purpose the payment was designed to serve. The Waldman court looked to state law to make this determination and concluded that the payment was not deductible as it served a law enforcement function.

The restitution payment at issue in this case was made pursuant to New Jersey law. Under New Jersey law, the court shall sentence a defendant to pay restitution in addition to a sentence of imprisonment or probation that may be imposed if (1) the victim suffered a loss and (2) the defendant is able to pay. N.J.S.A. 2C:44-2.b. The Supreme Court of New Jersey has said that "fines" are payments to punish the wrongdoer and to deter conduct that causes social harm and that "restitution" serves to rehabilitate the wrongdoer and to compensate the victims of the wrongdoer's conduct. State v. Newman, 132 N.J. 159, 167-69 (1993); State v. Harris, 70 N.J. 586, 592-93 (1993). In Newman, the court stated that restitution, strictly defined, requires repayment to the victim of the fruits of the crime. Newman, supra, at 168. In 1991, New Jersey's criminal code was amended to clarify that a "purpose of the criminal code sentencing provisions is to promote restitution to victims." Id. at 175. The Newman court also noted that historically, the function of restitution has been to compensate those who have suffered injuries resulting from another's wrongful conduct and that restitution in the criminal law was generally anticipated to provide the same remedy that it did in the civil law, and to reduce the obstacles that a victim confronts in the civil law in trying to obtain that remedy. Id. at 176. Furthermore, in New Jersey, "restitution is not technically punishment for a crime. Although restitution has aspects of rehabilitation and deterrence, which are also aspects of punishment, it is predominantly nonpenal in nature." State v. Rhoda, 206 N.J. Super. 584 (1986). Thus, under New Jersey law, restitution is primarily compensatory in nature with the goal of compensating the victim for his loss and as such is deductible under section 165(c)(2). See Stephens, supra, at 672-673. Thus, Taxpayer B may deduct the payments he has made and will make to Government Entity E and Government Entity F pursuant to the consent order in the years the payments were made and will be made provided that he received no contribution from any other party and included the amounts in his gross income in prior tax years.

CONCLUSION

We conclude that Taxpayer B may deduct the payments he made to the Insurance Company and to Government Entity E and Government Entity F in the years the payments were made or will be made, provided that he received or will receive no contribution from any other party and included the amounts he paid or will pay in his gross income in prior tax years.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Christopher F. Kane
Chief, Branch 3
(Income Tax & Accounting)

cc: