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Restitution and the Origin of the Claim

By Christopher Karachale • Wood & Porter • San Francisco

The breadth of business expense deductions allowable under Internal Revenue Code Section ("Code Sec.") 162(a) is broad. In fact, it is sometimes surprising just how arguably egregious a business expense can be while still being deductible. For example, provided they were incurred in your business, you can deduct punitive damages related to fraud. [*See* Rev. Rul. 80-211, 1908-2 CB 57.] The same is true for damages incurred in the remediation of environmental damage you caused (*Kerr-Mcgee Corp.*, FedCl, 2007-2 USTC ¶50,556, 77 FedCl 309, 317 (2007)).

Even statutory prohibitions do not always mean what they seem to say. For example, suppose you pay a fine or penalty related to your business dealings, the deduction for which is nominally disallowed under Code Sec. 162(f). You can *still* deduct that payment provided the fine or penalty is *compensatory* in nature. *See* TAM 200502041 (Jan. 14, 2005). So how did we get here and what is it that makes the Code Sec. 162(a) deduction so malleable?

ALSO IN THIS ISSUE

In part, the answer lies in the test applied by courts and the IRS to determine whether an expense is deductible. According to the Supreme Court, the origin and the character of the claim with respect to which an expense was incurred—rather than its potential consequences upon the fortunes of the taxpayer—is the controlling test for deductibility. [*See D. Gilmore*, SCt, 63-1 USTC ¶9285, 372 US 39, 49 (1963).]

In the words of the Tax Court, the origin of the claim test does not involve a "mechanical search for the first in the chain of events." [*V. Boagni, Jr.*, 59 TC 708, 713, Dec. 31,873 (1973).] Rather, it requires the following:

- Consideration of the issues involved
- The nature and objectives of the litigation
- The defenses asserted
- The purpose for which the amounts claimed as deductions were expended
- All other facts relating to the litigation

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Trivium

The origin of the claim test was most famously set forth in *Gilmore*. There, the Supreme Court attempted to distinguish the deductibility of business expenses from personal expenses. The Court ruled that a husband's legal expenses incurred in a divorce proceeding were nondeductible personal (rather than business) expenses since the wife's claims stemmed entirely from the marital relationship. [*Gilmore, supra*, 372 US, at 51.]

Consequences are different from origin. Thus, Mr. Gilmore's legal expenses could not be deducted even though his wife's claims might cause him to lose his controlling interest in three GM car dealer franchises. That was clearly a business, and it was his principal means of livelihood. Even Mr. Gilmore's claim that the reputation-damaging charges of marital infidelity might cause GM to exercise its right to cancel the husband's franchises carried no weight. [*Gilmore, supra*, 372 US, at 41.] These facts did not convert the *origin* of the legal expenses into a business expense.

Apart from the personal and business expense divide, the origin of the claim is also applied to distinguish immediately deductible expenses from expenses that must be capitalized. The division between these expenses appears to be even more nuanced. In *F.W. Woodward*, SCt, 70-1 USTC ¶9348, 397 US 572, 583 (1970), the Supreme Court ruled that whether costs are incurred in the acquisition of a capital asset is a simple "inquiry whether the origin of the claim litigated is in the process of acquisition itself."

Applying these rules is hardly easy. In *Anchor Coupling Co.*, CA-7, 70-1 USTC ¶9431, 427 F2d 429, 433 (1970), *cert. denied*, 401 US 580 (1970), the Seventh Circuit ruled that the origin and character of the claim with respect to which a settlement is made controls. Of course, there may be potential *consequences* to the business operations of a taxpayer, and those consequences may be dire. However, that is not the controlling test of whether a settlement payment is deductible or must be capitalized.

In short, the origin of the claim doctrine is applied by the IRS and courts pervasively in the context of business expenses. In general, this leaves taxpayers with only three options:

- A nondeductible personal expense
- An expense that must be capitalized (and possibly depreciated)
- An expense that is immediately deductible under Code Sec. 162(a), provided it is ordinary and necessary

In large part, every expense must fit into one of these three boxes.

Traveling to Restitution

The application of the origin of the claim doctrine is particularly interesting in the context of restitution payments. In general, restitution payments are made on account of criminal or civil misdeeds. Such payments are made to compensate either individuals or the government. Compensation, rather than punishment, is one of the central features of restitution as a concept. Hence, individuals are often allowed to deduct such restitution payments, but only as losses under Code Sec. 165(c)(2). [*See J.T. Stephens*, CA-2, 90-2 USTC ¶50,336, 905 F2d 667 (1990); LTR 200834016 (Aug. 22, 2008).]

Since the deduction is only allowed under Code Sec. 165(c)(2), the taxpayers must take a miscellaneous itemized deduction, rather than an above-the-line business deduction as Code Sec. 162 allows. That is a bad result. In fact, with the rise of the alternative minimum tax as one of the more prevalent features of our individual income tax law, a miscellaneous itemized deduction may translate to zero deduction.

New Day

A relatively recent letter ruling confirms that under appropriate circumstances, a restitution payment can be treated as a business expense, even if the criminal act emanates from a particular individual's activity. Since the payment is a business expense, the origin of the claim analysis appears to shoehorn the payment into the currently deductible box. The result, one could argue, cannot be otherwise.

In LTR 201045005 (Nov. 12, 2010), the taxpayer requesting the ruling was a domestic S corporation. The stock of the S corporation was entirely owned by a C corporation, and the stock of C corporation itself was owned by an individual and his wife. The individual worked as an employee of the S corporation (we'll call him "Exuberant Employee"), in addition to indirectly controlling the S corporation. Pursuant to its bylaws, the S corporation had agreed to indemnify its officers, directors and employees, including Exuberant Employee.

Through Exuberant Employee, the S corporation provided services to a business ("Bad Business") which invested money in certificates of deposit ("CDs") for its clients. Exuberant Employee found rates for bank CDs and assisted in placing CDs for the customers of Bad Business. He also produced and processed paperwork related to Bad Business's activities.

Toward the end of the engagement with Bad Business, Exuberant Employee discovered that Bad Business was embezzling client funds that were to be invested in CDs. Exuberant Employee reported this activity to the U.S. Attorney's Office. It was determined that Exuberant Employee (and the S corporation) did not participate in Bad Business's fraud. However, Exuberant Employee was found guilty of the crime of misprision because he delayed in reporting Bad Business's malfeasance. Exuberant Employee pled guilty and was sentenced to jail. More pertinently, Exuberant Employee was ordered to make a restitution payment to the clients of Bad Business.

(Three) Roads Diverge

The S corporation paid the restitution on behalf of Exuberant Employee (who, recall, owned and controlled the S corporation). The S corporation then sought to deduct the restitution payment. The letter ruling acknowledges that the restitution payment by the S corporation resulted from Exuberant Employee "providing operational services" to Bad Business. The ruling also states that Exuberant Employee's delay in reporting Bad Business's illegal activity "arose from his ordinary business activities, rather than a capital transaction."

Invoking the origin of the claim doctrine, the Letter Ruling sought to look to the source of the payment. Here, the ruling indicates that Exuberant Employee's "conduct was within the normal course of business activities he performed for the" S corporation. Moreover, the ruling finds that the S corporation made the restitution payment on behalf of Exuberant Employee because of its contractual obligation to do so. Therefore, the letter ruling

concludes, the restitution payment was a business expense, not a personal expense or a capital expenditure.

One might question the IRS's largesse in this particular ruling. The U.S Attorney's Office sentenced Exuberant Employee to jail for his actions. However, the IRS viewed such actions as within the normal business activity of Exuberant Employee and the S corporation.

In this respect, LTR 201045005 is good news for taxpayers. After all, it shows that a restitution payment can simply be considered a business expense. Once it is, it is surely bound to be immediately deductible rather than treated as a personal or capital expense.

Penalty Phase

Of course, there was the Code Sec. 162(f) fine or penalty hurdle. This subsection generally denies a deduction for the payment of fines or penalties to the federal or state governments. For the S corporation (and Exuberant Employee), the IRS ruled that the restitution payment was intended to be compensatory in nature, so the Code Sec. 162(f) disallowance was avoided.

In the end, it appears that the IRS saw the restitution payment purely through the lens of the origin of the claim doctrine. As such, it hardly seems likely that such a restitution payment could be deemed a personal expense or an expense that must be capitalized. Nevertheless, this seems as much about the factual presentation of the deduction as the origin of the claim.

Claims to Compare

Not all taxpayers are so lucky. Compare the facts of LTR 200834016 (Aug. 22, 2008), in which a physician ran his business through an S corporation. The physician was charged with making fraudulent claims to health insurance companies and ultimately made a restitution payment to the insurers. Unlike the S corporation and Exuberant Employee in LTR 201045005, the individual taxpayer in LTR 200834016 was allowed only a Code Sec. 165(c)(2) deduction for his restitution payment. [But *compare* the doctor in *P.D. Cavaretta*, 99 TCM 1028, Dec. 58,105(M), TC Memo. 2010-4 (2010), who was allowed a Code Sec. 162(a) deduction for a restitution payment related to his wife's fraudulent billing.]

Had the physician's S corporation (rather than the physician himself) sought to deduct the restitution payment in LTR 200834016, would the IRS have viewed the transaction differently? The facts of the LTR 201045005 and LTR 200834016 are similar enough to wonder why one restitution payment was afforded Code Sec. 162(a) treatment while the other was not. Could it be that the imposition of a corporate entity (or two) is enough to create the requisite business hook?

Conclusion—Start out on the Right Road

There may be a variety of potential explanations to help account for the different treatment in the two letter rulings. However, the factual similarities between the two rulings only reinforce the significance of the origin of the claim doctrine on restitution payments. Provided a taxpayer can demonstrate that the restitution payment was incurred in a business context (through the imposition of a corporate entity or otherwise), the origin of the claim doctrine seems to force the payment to be immediately deductible rather than personal or capital.