Internal Revenue Service

Number: **201528026**
Release Date: 7/10/2015

Index Number: 162.01-00, 162.02-00, 162.21-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B01
PLR-138683-14

Date:
April 13, 2015

Legend

Taxpayer:
Spouse:
Company:
Year 1:
Year 2:
Year 3:
Year 4:
X:
Y:
$1x:
$2x:
$3x:
$4x:
Z:

Dear :

This responds to your letter dated October 9, 2014, requesting a ruling that payments made by Taxpayer to the United States Government are deductible under Internal Revenue Code § 162(a).

Ruling Requested

Taxpayer requests a ruling that restitution payments made to the United States Government during Year 1 are a deductible business expense under Internal Revenue Code § 162(a) and not a fine or penalty under § 162(f).

Applicable Facts

Taxpayer is an individual who, together with Spouse, file joint income tax returns and utilize the cash method of accounting on a calendar year basis. From Year 2 through Year 3, Taxpayer was a consultant at Company, a partnership for tax purposes. In Year 4, Taxpayer became a principal in Company and was treated as a partner for tax purposes. Taxpayer was assigned in Year 4 to a group that sold Z. Company compensated Taxpayer for work performed and paid bonuses specifically related to his work on Z.

The United States prosecuted Company for activities related to its sale of Z. Taxpayer entered into a cooperation agreement and pled guilty to two criminal counts. The court sentenced Taxpayer to X of incarceration, Y of probation, a fine $1x, and a $2x special assessment. Neither count provided for forfeiture or restitution; however, Taxpayer agreed to pay restitution as part of the plea agreement in an amount to be determined by the sentencing court.

The sentencing court determined that the government's actual loss was $3x and that Taxpayer was responsible for $4x in restitution. The restitution judgment was imposed separately from Taxpayer's punitive sentence. The documents and representations provided by Taxpayer indicate that the restitution judgment was intended to compensate the United States and not serve a punitive purpose. Taxpayer unsuccessfully appealed the restitution judgment and paid the full restitution amount during Year 1. Taxpayer represents that he has not received any indemnification or compensation for any portion of the restitution payments and that Company has denied liability to indemnify Taxpayer.

Law

Section 162(a) provides that there is allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Treas. Reg. § 1.162-1(a) provides that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

Section 162(f) provides that no deduction shall be allowed under § 162(a) for any fine or similar penalty paid to a government for the violation of any law.

Treas. Reg. § 1.162-21(b)(1)(iii) provides that for purposes of § 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 whether civil or criminal.

Treas. Reg. § 1.162-21(b)(2) provides that compensatory damages paid to a government do not constitute a fine or penalty.

Discussion

To qualify as a deduction allowable under § 162(a), an expenditure must satisfy a five part test: it must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be necessary, and (5) be ordinary. Commissioner v. Lincoln Savings and Loan Association, 402 U.S. 345, 352 (1971). An expenditure satisfying the five part test may, nevertheless, be excluded if it is a fine or similar penalty under §§ 162(f) and 1.162-21.

As a threshold matter, we look at whether Taxpayer's payments to the United States are for a fine or similar penalty under §§ 162(f) and 1.162-21. Section 162(f) states that no deduction is allowed under § 162(a) for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(b)(2) provides that compensatory damages paid to a government do not constitute a fine or penalty.

All of the facts in this case indicate that the payments were compensatory restitution. First, under the plea agreement with the United States Attorney it is clear that the Taxpayer's payment of restitution was intended to compensate the United States for actual losses suffered as a result of Taxpayer's conduct. Second, Taxpayer received a punitive sentence of imprisonment and a fine. Third, the restitution and sentence of imprisonment were made at different times independent of each other. Lastly, the restitution was not made in lieu of forfeiture. Accordingly, the restitution payments to the United States were not a fine or similar penalty for purposes of § 162(f).

Having concluded that a deduction under § 162(a) is not precluded by § 162(f), we look to whether the restitution payments arose from Taxpayer's trade or business and, if so, whether it is an ordinary and necessary business expense rendering the payments deductible under § 162(a). Ditmars v. Commissioner, 302 F.2d 481, 485 (2nd Cir. 1962).

The controlling test to distinguish business expenses from personal or capital expenditures is the "origin of the claim" test. Anchor Coupling Company v. United States, 427 F.2d 429, 433 (7th Cir.1970), cert. denied, 401 U.S. 908 (1971). The origin of the claim test was first set forth by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963). In Gilmore, the Court held that the controlling test of whether an expense is "business" or "personal" is to consider the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences

upon the fortunes of the taxpayer. See also Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970).

The Tax Court has described the origin of the claim rule as follows:

> Quite plainly, the "origin of the claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose ... Consideration must be given to the issues involved, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.

Boagni v. Commissioner, 59 T.C. 708, 713 (1973), acq., 1973-2 C.B. 1.

In this case, the Taxpayer's restitution payments resulted from the provision of services to Company. These services related to work on Z that was performed at the direction of, and with the full knowledge of, Taxpayer's superiors at Company. It is clear that Taxpayer's illegal activities arose from ordinary business activities, i.e. the provision of services to Company's clients. Under the origin of claim test, Taxpayer's conduct was within the normal course of the business activities he performed for Company -- regardless of the fact that they were subsequently determined to be in violation of law. Therefore, after examining all the facts and circumstances, the payments for restitution were a business expense, and not a personal expense or a capital expenditure.

Furthermore, Taxpayer's business expense was ordinary and necessary if the restitution payments were not a capital expense, were appropriate and helpful to the Taxpayer's business, and were reasonable under the circumstances. See Welch v. Helvering, 290 U.S. 111, 113-14 (1933). It is well settled that it is ordinary and necessary to defend, and when necessary settle, claims arising from a taxpayer's trade or business. See e.g. Id.; Kornhauser v. United States, 276 U.S. 145, 152-53 (1928); Ditmars, 302 F.2d at 485; Bradford v. Commissioner, 70 T.C. 584, 590 (1978); Rev. Rul. 80-211, 1980-2 C.B. 57. Taxpayer was no longer engaged in the trade or business at the time of the payments; however, this has no affect if the restitution payments would have been an ordinary and necessary business expense had he still been engaged in the trade or business. Ditmars, 302 F.2d at 485; Dowd v. Commissioner, 68 T.C. 294, 302 (1977); Rev. Rul. 67-12, 1967-1 C.B. 29. Based on the facts and circumstances, Taxpayer's restitution payments were ordinary and necessary business expenses.

Taxpayer represents that the restitution payment was paid or incurred in Year 1, that he has not received any indemnification or compensation for any portion of the restitution payments, and that Company has denied liability to indemnify Taxpayer.

Conclusion and Ruling

Based solely on the facts and representations submitted, we conclude and rule as follows:

Under the origin of the claim test, Taxpayer's restitution payments made to the United States had their origin in the conduct of Taxpayer's trade or business. An examination of all the facts indicates that the restitution was an ordinary and necessary business expense, and not a personal expenditure, or capital expenditure. In addition, the restitution payments were not for a fine or similar penalty for purposes of § 162(f). Accordingly, Taxpayer's restitution payments made to the United States during Year 1 are deductible under § 162(a).

Disclaimers and Limitations

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

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

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,

Andrew M. Irving
Senior Counsel, Branch 1
(Income Tax & Accounting)