Deducting Restitution: Above or Below the Line

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In this article, Wood looks at restitution payments and the continuing struggles between taxpayers and the IRS over their tax treatment. Examining the recent *Cavaretta* case in the context of prior restitution authorities, he concludes that slogging through the details can often yield deductions despite the IRS's reference to fine and penalty authorities.

Restitution is the act of restoring something to its rightful owner or to its prior state. Most commonly ordered by a judge in a criminal case, restitution involves the guilty party paying back the victim. As part of the offender's sentence, it can be ordered in adult or juvenile cases following a conviction or guilty plea.

Clearly, it is most commonly thought of as a criminal remedy. Indeed, there are sources suggesting that in some contexts restitution can only be ordered when someone has been convicted.[1] Yet it is indisputable that restitution is sometimes ordered in breach of contract, unjust enrichment, and fiduciary duty cases.[2] The term seems to be in considerably wider use today than merely in criminal matters.

As we will see, even if a payment is labeled as restitution, it may not be clear how it should be treated for tax purposes. The restitution label may begin rather than end the tax inquiry.

General Rules of Deductibility

Traditionally, the IRS has analogized restitution payments to penalties. That is curious, for almost by definition, restitution is paid to a private party. In contrast, a nondeductible fine or penalty is always paid to the government.[3] Despite this seemingly critical factual distinction, the identity of the payee is not the only factor at play.

Even with a private payee, the IRS may argue the fine or penalty analogy and seek to disqualify restitution from a deduction as an ordinary and necessary business expense.[4] At the same time, it is not uncommon for the IRS to explicitly allow deductions for restitution.[5] That can make this area quite confusing. Although clients tend to ask questions, such as ''whether restitution is deductible,'' the restitution label may not be all that important.

Often, the line is litigated between business expense treatment under section 162(a) and loss treatment under section 165. Section 165(c)(1) allows a deduction for losses incurred in a trade or business. Section 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit. Several cases may be cited for the proposition that a repayment of fraudulently obtained funds cannot be deducted under the first subsection.[6] The more limited below-the-line deduction of section 165(c)(2) is, however, generally available.[7]

Yet there is also authority suggesting there should be *no* deduction for payments in satisfaction of criminal liability, even if denominated as restitution.[8] The authorities often look to state law to determine whether a payment of restitution is (or is not) in satisfaction of a *criminal* liability. It might seem obvious that restitution ordered in connection with a criminal case would be part of the punishment. Yet it is important whether state law

[1]*See Hughey v. United States*, 495 U.S. 411 (1990), ruling that a restitution payment under the Victim and Witness Protection Act of 1982, 18 U.S.C. sections 3579, 3580, was only authorized for the loss caused by the specific conduct for which the defendant was *convicted*. Note that this standard was subsequently amended by the Crime Control Act of 1990, 18 U.S.C. section 3663(a)(3).

[2]*See, e.g.*, *Mobil Oil Exploration & Producing Southeast v. United States*, 530 U.S. 604 (2000).

[3]*See* section 162(f): ''No deduction shall be allowed . . . for any fine or similar penalty *paid to a government* for the violation of any law'' (emphasis added).

[4]*See Kraft v. United States*, 991 F.2d 292 (6th Cir. 1993), *Doc 93-4425, 93 TNT 79-15*, *cert. denied*, 510 U.S. 976 (1993).

[5]*See* LTR 200834016 (May 20, 2008), *Doc 2008-18217*, *2008 TNT 165-15*.

[6]*See Kraft*, 991 F.2d 292; *see also Mannette v. Commissioner*, 69 T.C. 99 (1978).

[7]*See Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990); *see also* Rev. Rul. 65-254, 1965-2 C.B. 15.

[8]*See Waldman v. Commissioner*, 88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).

treats the restitution as part of the punishment or as a payment to help rehabilitate the wrongdoer and compensate the victims.

This is not always a precise inquiry, and requires a review of the particular fact pattern and the particular restitution. One should also assess how the state generally treats restitution. This is reminiscent of the distinction between compensatory and noncompensatory fines. That odd distinction is often used to allow some fines to be deducted despite the prohibition on deductions in section 162(f).

Dancing Around the Line?

How, then, does one analyze the tax position of a payer of restitution? It is not a simple question. *Cavaretta v. Commissioner*[9] provides an excellent recent example.

Karen Cavaretta worked in her husband's dentistry practice and billed insurance companies for work not done. She pleaded guilty to fraud charges, and her husband repaid the money and deducted the payments as business expenses on their joint return. The IRS disagreed, arguing that the payments were not business expenses and could be deducted (given their nature as restitution) only as losses. The IRS also asserted negligence penalties.

The facts are detailed, although only the basics seem important. There was no question the fraudulent overcharges were improper and that there was a criminal conviction. After her guilty plea for healthcare fraud, Karen was sentenced to 18 months in prison, with two years of supervised release thereafter. She was ordered to pay a $100 assessment as required under the federal sentencing guidelines, but the judge imposed no fine or restitution.

However, attached to the sentencing judgment was a letter from Karen's attorney saying that she would pay to the defrauded insurance company $600,000 to "settle all civil claims against the Cavarettas . . . and specifically those claims arising from matters dealt with in the criminal action brought in the Western District of New York." The letter detailed the payments, with the first payment of $230,000 to be paid through Karen's lawyer. The rest was to be paid directly to the insurance company. In return, the insurance company wrote a letter supporting a home confinement sentence.

Karen's lawyer sent the $230,000 check to the insurance company. He included a letter stating that he had been instructed by Karen's probation officer to transmit the money directly to the company. The Cavarettas deducted the payment on their Schedule C for the dental practice.

Just Business?

The Cavarettas' deductions generated net operating losses that they carried back to the three preceding years. Based on those carrybacks, they received tentative refunds. The IRS thereafter changed its mind and sent them a notice of deficiency for all three years.

The Tax Court agreed with the IRS that the payments were restitution made as part of Karen's plea deal. Yet that hardly ended the case. The court noted that most of the documents in the record referred to the payments as "restitution," including the settlement agreement, correspondence, and the sentencing judgment itself. The Tax Court then considered whether the restitution moniker was sufficient to resolve its tax treatment.

The IRS argued that it was and that *Stephens v. Commissioner*[10] suggests restitution can *never* be deducted under section 162, and only *sometimes* under section 165. The Tax Court disagreed. *Stephens*, said the court, did not hold that *all* restitution is automatically deductible or nondeductible. Rather, *Stephens* carefully distinguished between punitive and compensatory restitution, even in criminal cases.

In *Cavaretta*, the Tax Court sought to resolve whether this particular restitution was punitive in nature. Referring to the Second Circuit's decision in *Stephens*, the Tax Court found that the Cavarettas had a good case. It was stronger than that in *Stephens*, in which the court found the restitution to be more compensatory than punitive. After all, it was not at all clear that the restitution was part of Karen's criminal sentence.

The facts and documents suggested otherwise. The Tax Court was even able to quote from the sentencing judge's orders, which required the defendant to comply with a "*civil* restitution agreement" (emphasis added). There were other notes in the criminal sentencing paperwork, and they too were telling. The judge had written "none" adjacent to a line indicated for the "total amount of restitution." There was also a restitution column on the forms — containing a zero.

Concluding that *this* restitution was compensatory and not punitive in nature, the Tax Court then considered whether these payments should be ruled as business expenses deductible under section 162. Already having implicitly cast aspersions on the government's position in the case, the Tax Court continued to do so, alluding to the IRS as "poking around" for other arguments. The Tax Court seemed impressed with the *bona fides* of the taxpayers. Karen's husband (the dentist, Peter) credibly testified in Tax Court that he would have lost his dental practice if he had not settled the matter.

Joint Obligation

The liability to pay back the defrauded insurance company was a liability arising out of a contract claim. It was Peter who as the practicing dentist had contracts with the insurance company that had to be settled. The court had to analyze the *Lohrke v. Commissioner*[11] line of authorities dealing with deductions claimed by one person based on another's obligation. That was no problem here.

Indeed, the court was able to find that *both* of the Cavarettas were obliged to make the payments. Given the way in which their business was conducted and the way in which the demands from the insurance company were made to Peter and the business, this was not merely Karen's problem.

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[9]T.C. Memo. 2010-4, *Doc 2010-222*, *2010 TNT 3-7*.

[10]905 F.2d 667 (2d Cir. 1990), discussed below.

[11]48 T.C. 679 (1967).

True, it was Karen who had admitted to the fraudulent scheme, but *both* of them were legally obligated to repay the money. Plus, when the insurance company ultimately issued releases, it released *both* Karen and Peter. Of course, these expenses were also claimed on a Schedule C. The dental business had been conducted and consistently reported on Schedule C of their returns.

Ultimately, the Tax Court found this circumstance similar to that in *Musgrave v. Commissioner*.[12] In that case, a business repaid a client after one of its employees embezzled money. The Tax Court held that the repayment was an ordinary and necessary business expense. The court stressed in *Musgrave* that deductibility depends on the relation of the payment to the business claiming the deduction. It could not be otherwise.

In other words, said the court, ''don't look at the situation from the perspective of the embezzling employee, but from that of the business actually claiming the deduction and see if there is a reasonable business purpose for repayment.''[13] In *Musgrave*, the business taxpayer was not filing a joint return with the misbehaving employee. Karen and Peter, however, had filed a Schedule C and a joint return. Seeking to placate the IRS — which was arguing in *Cavaretta* that Karen was a wrongdoer and should not be favored with *any* kind of tax deduction — the Tax Court seemed to agree that given Karen's bad behavior, she probably should not get a carryback generating deduction had she been filing by herself.

Yet these were *joint* returns. Even though Karen could not deduct the payments as business expenses on the Cavarettas' joint return, the Tax Court concluded, Peter was not similarly barred. The Cavarettas were correct to combine their deductions in calculating their NOL, and the carryback was proper.

Not only that, but the Tax Court had to address what it referred to as ''the Commissioner's final salvo.'' The IRS's moral crusade had one more argument: The Cavarettas would be offsetting business expenses against illegal income in those prior years. Rejecting this IRS claim too, the Tax Court simply said that the tax rules governing NOL carrybacks are unconcerned with the *source* of income in the year of the carryback. Enough said.

Turning at last to penalties, the Tax Court rejected the application of negligence penalties, noting that the penalties would evaporate regarding the deficiencies the Tax Court had rejected. Moreover, it found that *other* penalties were inappropriate too. Indeed, the Tax Court noted that even if the court was wrong on the substantive issue of characterizing the payments as deductible business expenses, it would not be imposing penalties. The facts of the case and the uncertain legal treatment of restitution were such that one could not say the Cavarettas were negligent.

[12]T.C. Memo. 1997-19.

[13]*See Cavaretta*, T.C. Memo. 2010-4, slip op. p. 14.

Fines, Late Fees, and Compensatory Payments

Cavaretta isn't an aberration, and it seems odd that the Service fights such cases. True, section 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law. Most tax advisers know this, and enunciate it as an absolute rule. In practice, however, this deduction prohibition has never been absolute. In fact, a late filing fee designed to encourage prompt compliance with the law is not a fine for this purpose.[14]

Another exception relates to so-called compensatory fines, imposed only to compensate a governmental entity for harm it has suffered, as distinguished from a fine with a punitive motivation. Under this rationale, a fine that is essentially a reimbursement to the government for the amount of lost custom taxes has been held deductible.[15] Similarly, a payment to the Clean Water Fund to avoid prosecution for water pollution was held deductible,[16] although the regulations take the position that civil environmental fines are nondeductible.[17]

For both tax and nontax reasons, taxpayers make every attempt to avoid penalty characterization and to emphasize the remedial effects (or intent) of whatever the payment happens to be.[18] Even fines that may appear on their face to be punitive in nature may be deductible, as long as the taxpayer can prove the requisite compensatory character. For example, ''liquidated damages'' imposed for the violation of truck weight limitations have been held to be deductible.[19]

Although liquidated damages are often equated with penalties, these liquidated damages compensated the state for damage to the highways caused by overweight vehicles. Even when denominated as fines, liquidated damages imposed by contract have been viewed as compensatory.[20] Yet it can be difficult to show that a fine was imposed with a compensatory motive.

Close Relative?

Traditionally, the IRS has analogized restitution to a penalty, and the courts have not always disagreed. For example, in *Kraft v. United States*,[21] the Sixth Circuit held that restitution paid to Blue Cross/Blue Shield arising out of a criminal action for fraud was nondeductible. Although the restitution was paid to a private party, the court held that the payments were penal in nature.

[14]*See* S. Rep. No. 92-437, at 73, 74 (1971).

[15]*Middle Atlantic Distributors, Inc. v. Commissioner*, 72 T.C. 1136 (1979), *acq.*, 1980-2 C.B. 2.

[16]*S&B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226 (1980).

[17]Reg. section 1.162-21(c), examples 2 and 7.

[18]*See* William L. Raby, ''Two Wrongs Make a Right: The IRS View of Environmental Cleanup Costs,'' *Tax Notes*, May 24, 1993, p. 1091, *Doc 93-5780*, or *93 TNT 108-113*; and Raby, ''When Will Public Policy Bar Tax Deductions for Payments to Government?'' *Tax Notes*, Mar. 27, 1995, p. 1995, *Doc 95-3168*, or *95 TNT 57-74*.

[19]*Mason-Dixon Lines, Inc. v. United States*, 708 F.2d 1043 (6th Cir. 1983).

[20]Rev. Rul. 69-214, 1969-1 C.B. 52.

[21]991 F.2d 292 (6th Cir. 1993), *Doc 93-4425, 93 TNT 79-15*, *cert. denied*, 510 U.S. 976 (1993).

In *Waldman v. Commissioner*,[22] the court noted that when a payment serves both law enforcement and compensatory functions, one must determine which purpose the payment was designed to serve. The court looked to state law, concluding that the payment was not deductible because it was in satisfaction of a criminal liability.

Similarly, in *Bailey v. Commissioner*,[23] restitution connected with a sentence was not deductible, even though it served to settle a class action. *Bailey* involved a taxpayer who tried to deduct restitution that had previously been characterized as a fine. The transmutation of a nondeductible fine into restitution made it ''against public policy'' — surely a self-justifying phrase — to allow a deduction for that sort of restitution.

The public policy overlay to tax deductions is dangerous and uncertain. Indeed, whether Congress accomplished its goal of delimiting the public policy exception to deductions for fines or similar penalties (along with the other disallowances of section 162(c) and (g)) remains unclear.[24] This ''against public policy'' standard is a canard to which we return below.[25]

Restitution and Losses

A number of courts have found restitution to be deductible. Indeed, even the IRS sometimes agrees. For example, in LTR 200834016, the IRS ruled that while a doctor could not deduct restitution as a business expense, he could deduct it as a loss incurred in a transaction entered into for profit. The doctor practiced in New Jersey through his wholly owned professional corporation (an S corporation), and he derived income primarily from insurance payments made on healthcare claims from his patients.

The doctor was indicted for insurance fraud, pleaded guilty, and settled with the state of New Jersey. He paid a criminal penalty to New Jersey, received a jail sentence, and agreed to provide restitution to the insurance companies. He made the required payments personally, and no restitution was paid to a governmental entity. The question was whether the restitution to the insurance companies as part of his criminal plea agreement could be deducted under section 165(c)(1) or (c)(2).

Section 165(c)(1) allows a deduction for losses incurred in a trade or business, and section 165(c)(2) allows losses incurred in a transaction entered into for profit. A number of cases stand for the proposition that a repayment of fraudulently obtained funds is not deductible under the first provision.[26] The IRS therefore concluded there was no deduction available under section 165(c)(1) for the doctor's restitution payments.

[22]88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).

[23]756 F.2d 44 (6th Cir. 1985).

[24]*See* S. Rep. No. 91-552, at 273, 274 (1969): ''The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive.''

[25]*See* Robert W. Wood, ''Denying Deductions Based on Public Policy,'' *Tax Notes*, Mar. 27, 2006, p. 1415, *Doc 2006-5368*, or *2006 TNT 59-34*.

[26]*See Mannette v. Commissioner*, 69 T.C. 99 (1978).

The deduction under section 165(c)(2) is another matter because taxpayers who repay embezzled funds normally do qualify.[27] Even a convicted arsonist was entitled to a loss deduction under section 165 when he paid restitution to an insurance company.[28] However, merely *calling* something restitution does not make it deductible. Indeed, a deduction is not allowed when payments are made in satisfaction of criminal liability, even if the payments are denominated as restitution.[29]

The IRS looked to New Jersey law, under which restitution was a payment solely to the victim and imposed if the victim suffered a loss and the defendant was able to pay. New Jersey law provided that fines were payments to punish the wrongdoer, while restitution was to rehabilitate the wrongdoer and compensate the victims. It was not punishment. While ''restitution has aspects of rehabilitation and deterrence, which are also aspects of punishment, it is predominately non-penal in nature.''[30] Therefore, LTR 200834016 concludes that the doctor's restitution was deductible under section 165(c)(2).

Restitution also featured prominently in *Jon T. Stephens v. Commissioner*,[31] a case the Tax Court relies on in *Cavaretta*. After defrauding his employer (Raytheon), Stephens was sentenced to five years in prison and was ordered to pay a fine. However, the court allowed Stephens to make restitution to Raytheon for the amount he embezzled, plus interest. In return, the court changed his prison sentence to probation. Stephens had already paid tax on the receipt of the embezzled funds, so he deducted the restitution payment, which the IRS challenged.

In Tax Court, Stephens asserted that the restitution was deductible as an investment loss under section 165(c)(2). The IRS asserted that a deduction was disallowed entirely by section 162(f), or that if section 165 was the governing provision, public policy considerations should prevent any deduction. The Tax Court had no trouble determining that section 165 was the governing code section.

Although the court found that Stephens's restitution payment was not an ordinary and necessary business expense, it was part of a transaction for profit. Even though the Tax Court found section 162(f) not to apply, it noted that the same considerations extend to deductibility under section 165(c)(2). The Tax Court held that Stephens could not deduct the restitution payment, since it arose in his criminal conviction. Stephens appealed to the Second Circuit, which reversed, allowing Stephens to deduct it.

Absent application of the public policy doctrine, Stephens was entitled to the deduction, ruled the appellate court. The court framed the question as whether a deduction for restitution of embezzled funds ''so sharply

[27]*See* Rev. Rul. 65-254, 1965-2 C.B. 15.

[28]*See* Rev. Rul. 82-74, 1982-1 C.B. 110.

[29]*See Waldman v. Commissioner*, 88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988); *see also Kraft*, 991 F.2d 292.

[30]*See State v. Rhoda*, 206 N.J. Super. 584, 590 (1986).

[31]93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990).

and immediately frustrates a governmentally declared public policy that the deduction should be disallowed.'' The Second Circuit acknowledged that Congress codified the public policy doctrine in 1969 and that this codification was intended to be all inclusive. However, this codification appears only in section 162, not in section 165.

Nevertheless, the court reached the conclusion that allowing Stephens a deduction under section 165(c)(2) would not severely and immediately frustrate public policy. Besides, if Stephens could not claim a deduction, the court noted, there would be a double sting. He had already paid taxes on the embezzled funds. Interestingly, the court justified the application of the public policy doctrine by analogizing the situation before it to one arising under section 162(f), where the public policy doctrine no longer applies.[32]

Stephens's restitution payment was primarily a remedial measure designed to compensate Raytheon. It was not a fine or similar penalty. Stephens paid his former employer, not the government. Of course the presence of a private payee should be sufficient to bar the application of section 162(f) and allow the deduction. Nevertheless, the court hedged its conclusion, noting that a payment to a private party will not *always* insulate restitution from the public policy exception of section 165.

[32]*See also Ginsburg v. Commissioner*, T.C. Memo. 1994-272.

Taxpayers sometimes go to extreme lengths to get their deductions. In *Russell Spitz v. Commissioner*,[33] the taxpayer was secretary-treasurer and part owner of a building contractor. Spitz was convicted of theft, and as a condition of probation, was ordered to pay $5,000 in restitution to the victim. When the IRS denied the deduction, Spitz paid the tax and sued for a refund. The IRS argued that the $5,000 payment was a fine or similar penalty paid to a government for violation of law, and thus was nondeductible.

The court disagreed, since it was payment of an amount due and owing and was not paid to a government. The IRS also argued that allowing a deduction would frustrate the defined state policy against theft by a contractor. Although the court did not address the codification of the public policy doctrine, it quickly disposed of the Service's argument, noting that the IRS failed to establish that restitution of stolen funds frustrates state policy. Not only did the court in *Spitz* disagree with the IRS's arguments and refuse to grant the IRS summary judgment, but on its *own* initiative, it granted summary judgment for Spitz, allowing him the deduction.

Conclusion

Restitution payments, compensatory fines, and remedial penalties can all be fair game for tax deductions, though the facts and the law are all-important. The area is so confusing that taxpayers can be forgiven for believing that virtually all of their payments should be deductible. But the IRS is not very forgiving and not very tolerant of such claims. Taxpayers have to consider the facts about particular conduct, related criminal or other civil proceedings, the purpose and scope of an ordered payment, the statutory or regulatory scheme under which the payment is awarded, and the particular nature and intent of any restitution.

[33]432 F. Supp. 148 (1977).