(C) Tax Analysts 2011. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Deducting Restitution Under the Origin of the Claim Doctrine

By Robert W. Wood and
Christopher A. Karachale

Robert W. Wood

Christopher A. Karachale

Robert W. Wood practices law with Wood LLP in San Francisco (http://www.woodllp.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com. Christopher A. Karachale is an associate with Wood LLP.

The origin of the claim doctrine controls the tax character of payments made to resolve disputes. It also has been used to help determine whether a payment made to the government is a nondeductible fine or penalty. The authors analyze recent authorities in this increasingly important field.

Copyright 2011 Robert W. Wood and
Christopher A. Karachale.
All rights reserved.

The general rule is that payments to resolve litigation in the course of a trade or business are deductible. Nevertheless, the code states that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law."[1] This provision denies a deduction for criminal and civil penalties, as well as for sums paid in settlement of potential liability for a fine.[2]

The latter element of the limitation often causes great controversy. It may be clear that a fine will be imposed when a potential liability is satisfied. Whether a fine or penalty would be imposed in the absence of a settlement may depend on intent and other factors.[3] However, section 162(f) does not require an intentional violation of law for denial of a deduction if a fine is imposed. A deduction is generally disallowed for a fine even if the violation is inadvertent or if the taxpayer had to violate the law to operate profitably.[4]

The nondeductibility of fines and penalties creates significant incentives to avoid that rule. The resulting legal wrangling is well illustrated by Exxon's experience after the *Exxon Valdez* oil spill litigation. According to the Congressional Research Service, Exxon's $1.1 billion settlement cost a maximum of $524 million after tax.[5]

Nontax professionals may find those figures astounding, but the deductions seem obvious to tax advisers. That environmental disaster has been eclipsed by BP's more recent catastrophic spill, and the tax impact of those damage figures may turn out to be even more momentous. The obvious point is that damages are usually deductible by businesses, and that even some fines and penalties are too.

Indeed, when fines and penalties have a compensatory purpose, they may be deductible.[6] For example, in *Jenkins v. Commissioner*,[7] the Tax Court held that a shareholder of a fertilizer manufacturer was entitled to deduct through his S corporation amounts paid as penalties for deficiencies in the fertilizer produced by his company. The purpose of the state penalty legislation was to compensate the consumer, not punish the manufacturer. The penalty was calculated by the value of the missing ingredient, plus an amount to compensate for additional crop yield.

Thus, it is important to look beyond mere fine or penalty language to the purpose of the enabling

---

[1] Section 162(f).

[2] Reg. section 1.162-21(b).

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

[4] *Tank Truck Rentals Inc. v. Commissioner*, 356 U.S. 30 (1958).

[5] Also announced by former Rep. Gerry E. Studds. The CRS study determined that more than half of the $900 million in civil damages could be deducted on Exxon's federal income tax returns. The study also indicated that because the civil penalties would be paid out over 10 years, the real return to the government would be significantly eroded by inflation. *See* Ian K. Louden, "Tax Deductions Will Help Exxon Slip Away From Much of Its Oil Spill Liability, Says CRS," *91 TNT 63-4*.

[6] TAM 200629030, *Doc 2006-15299*, *2006 TNT 157-17*.

[7] T.C. Memo. 1996-539, *Doc 96-32146*, *96 TNT 242-12*.

statute.[8] Of course, merely concluding that a penalty is civil rather than criminal does not get the taxpayer out of the woods. For example, in *Hawronsky v. Commissioner*,[9] the Tax Court held that section 162(f) prohibits deducting treble damages for breach of a scholarship contract, because the damages constituted a statutorily prescribed penalty.[10]

Public Policy Restrictions?

Occasionally, the IRS has objected to a deduction on public policy grounds. Fortunately, the Supreme Court determined that the IRS could not disallow deductions under a general public policy theory.[11] Indeed, that a liability is based on the taxpayer's fraud, breach of fiduciary duty, or mismanagement is generally not enough to prevent a deduction as long as the liability arose out of the taxpayer's trade or business.

Examples include cases in which:

- damages caused by a taxpayer's fraud in negotiating a lease were held deductible[12];
- damages paid by a stockbroker for improperly churning a client's account were held deductible[13];
- damages paid by a director for breach of fiduciary duty to a corporation were held deductible[14];
- damages paid by an executive for mismanagement and misuse of corporate assets were held deductible[15]; and
- punitive damages paid by a corporation to a victim of a fraudulent scheme in settlement of a breach of contract and fraud action were held deductible.[16]

Origin of the Claim

The origin of the claim test is classically invoked in evaluating the nature of gross receipts recovered in a lawsuit. However, it can be of equal importance in considering deductions. According to the Supreme Court, the origin of the claim requiring the expense — rather than its potential consequences on the fortunes of the taxpayer — is the controlling test for deductibility.[17]

The origin of the claim test does not involve a "mechanical search for the first in the chain of events."[18] Rather, it requires:

- 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; and
- all other facts relating to the litigation.

Root Cause

The origin of the claim test was most famously enunciated in *Arrowsmith v. Commissioner*.[19] In that case, the two shareholders of a corporation liquidated and divided the proceeds of their entity. They treated the distributions of corporate profits as subject to tax at capital gains rates. A judgment was rendered against the corporation, and after paying the judgment (on behalf of the old company), the former shareholders sought ordinary and necessary business deductions for the payments.

The Supreme Court found that the payments could only be treated as capital losses. The taxpayers were required to pay the judgment because of the liability imposed on them as transferees of liquidated corporation's assets. It was plain that their liability as transferees was not based on any ordinary business transaction apart from the liquidation proceedings.

A more universal iteration of the origin of the claim doctrine came in *United States v. Gilmore*.[20] There, the Supreme Court invoked the origin of the claim theory to distinguish business expenses from personal expenses. The Court held that a husband's legal expenses incurred in a divorce proceeding were nondeductible and were personal rather than business because the wife's claims stemmed entirely from their marital relationship.[21]

Consequences, we are told, are different from origin. Thus, 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 Gilmore's claim that the reputation-damaging charges of marital infidelity might cause GM to exercise its right to cancel his franchises was personal, not business.[22] Those facts did not change the origin of the legal expenses into one emanating from the business.

---

[8]*Mason & Dixon Lines Inc. v. United States*, 708 F.2d 1043, 1047 (6th Cir. 1983).

[9]105 T.C. 94 (1995), *Doc 95-7783*, *95 TNT 155-9*.

[10]*See also* William L. 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*.

[11]*Commissioner v. Tellier*, 383 U.S. 687 (1966).

[12]*Helvering v. Hampton*, 79 F.2d 358 (9th Cir. 1935).

[13]*Ditmars v. Commissioner*, 302 F.2d 481 (2d Cir. 1962).

[14]*Graham v. Commissioner*, 326 F.2d 878 (4th Cir. 1964).

[15]*Great Island Holding Corp. v. Commissioner*, 5 T.C. 150 (1945), *acq.* 1945 C.B. 3 (1945); *acq. sub nom.*, 1945 C.B. 7.

[16]Rev. Rul. 80-211, 1980-2 C.B. 57.

[17]*See United States v. Gilmore*, 372 U.S. 39, 49 (1963).

[18]*Boagni v. Commissioner*, 59 T.C. 708, 713 (1973).

[19]344 U.S. 6 (1952).

[20]372 U.S. 39 (1963).

[21]*Id.* at 51.

[22]*Id.* at 41.

(C) Tax Analysts 2011. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The origin of the claim is also applied to distinguish immediately deductible expenses from expenses that must be capitalized. Unlike the personal versus business chasm, the division between those expenses is considerably more nuanced. In *Woodward v. Commissioner*,[23] the Supreme Court concluded that determining the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property requires a simple ''inquiry whether the origin of the claim litigated is in the process of acquisition itself.''

Such phrasings can be pleasing to English majors who become tax lawyers. But applying those rules is hardly easy. In *Anchor Coupling Co. v. United States*,[24] the Seventh Circuit held that the origin and character of the claim controls the treatment of the settlement. Of course, there may be consequences to the taxpayer's business operations, even dire ones. However, that is not the controlling test of whether a settlement payment is deductible or must be capitalized.[25]

The origin of the claim doctrine is applied pervasively by the IRS and courts in the context of business expenses. That often leaves taxpayers with the following menu:

- a nondeductible personal expense;
- an expense that must be capitalized (and possibly depreciated); or
- an expense that is immediately deductible under section 162(a), provided it is ordinary and necessary.

Most expenses will fit into one of those boxes.

Restitution

The application of the origin of the claim doctrine is particularly interesting in the context of restitution. In general, restitution payments are made on account of criminal or civil misdeeds and may compensate individuals or the government. Despite the remedial character of restitution payments, they are often grouped in the fine or penalty category.

As a result, the fine or penalty taint is often present. For example, in *Kraft v. United States*,[26] the Sixth Circuit held that payments of restitution to Blue Cross and Blue Shield arising out of a criminal action for fraud were nondeductible penalties. But compare *Stephens v. Commissioner*,[27] in which the court *did* allow the taxpayer to deduct a restitution payment.

Stephens embezzled funds from his employer, Raytheon, and was sentenced to prison. The court allowed Stephens to make a restitution payment in return for a reduced sentence. The IRS argued that the deduction would take the sting out of Stephens's punishment.

Nevertheless, the court observed that Stephens's restitution payment was primarily a remedial measure, not a fine or similar penalty. Indeed, Stephens's payments were meant to compensate his victims. The court noted that ''compensatory payments generally 'return the parties to the status quo ante.'''[28]

Tax Treatment of Restitution Payments

In cases such as *Stephens*, the taxpayer was allowed to deduct the restitution payment. However, the deduction is only allowed as a loss under section 165(c)(2).

Of course, with a loss under section 165(c)(2), the taxpayers must take a miscellaneous itemized deduction rather than an above-the-line business deduction, as section 162 allows. That is a bad result. In fact, with the rise of the alternative minimum tax as a prevalent feature of our individual income tax, a miscellaneous itemized deduction may translate into no deduction.

New Day

Fortunately, under appropriate circumstances a restitution payment can be deducted above the line as an ordinary and necessary business expense. That is true even if the criminal act emanates from a particular individual's activity. Because 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, could not be otherwise.

In LTR 201045005,[29] the taxpayer was a domestic S corporation. The stock of the S corporation was entirely owned by a C corporation, and the stock of the 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. Under 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) that 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.

---

[23] 397 U.S. 572, 583 (1970).

[24] 427 F.2d 429, 433 (7th Cir. 1970).

[25] *Id.*

[26] 991 F.2d 292 (6th Cir. 1993), *Doc 93-4425*, *93 TNT 79-15*.

[27] 905 F.2d 667 (2d Cir. 1990).

[28] *Id.* at 673 (quoting *Colt Industries Inc. v. United States*, 11 Cl. Ct. 140, 146 (1986), *aff'd*, 880 F.2d 1311 (Fed. Cir. 1989)).

[29] *Doc 2010-24299*, *2010 TNT 219-22*.

(C) Tax Analysts 2011. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Toward the end of his engagement with Bad Business, Exuberant Employee discovered that Bad Business was embezzling client funds that were to be invested in CDs. He reported that 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. He pleaded 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 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 says 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. It says 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 those actions as within the normal business activity of Exuberant Employee and the S corporation.

In that respect, LTR 201045005 is good news for taxpayers. After all, it shows that a restitution payment can simply be considered a business expense.

Penalty Phase

Of course, there was the section 162(f) fine or penalty hurdle. That subsection generally denies a deduction for the payment of fines or penalties to 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 section 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 this type of 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,[30] 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 section 165(c)(2) deduction for his restitution payment.[31]

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 LTR 201045005 and LTR 200834016 are similar enough that it's curious why one restitution payment was afforded section 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, their factual similarities only reinforce the significance of the origin of the claim doctrine for restitution payments. It will be important to demonstrate that the restitution payment was incurred in a business context (through a corporate entity or otherwise). If one can get over that hurdle, the origin of the claim doctrine helps viewing the payment as a business expense.

---

[30]*Doc 2008-18217*, *2008 TNT 165-15*.

[31]*But compare* the doctor in *Cavaretta v. Commissioner*, T.C. Memo. 2010-4, *Doc 2010-222*, *2010 TNT 3-7*, who was allowed a section 162(a) deduction for a restitution payment related to his wife's fraudulent billing.

(C) Tax Analysts 2011. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.