



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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Dear \_\_\_\_\_ :

This letter responds to a request for information submitted on your behalf by your representative. Your representative has requested information concerning the circumstances under which a court-ordered criminal restitution payment may be deductible under § 162 or 165 of the Internal Revenue Code.

Ordinary and necessary expenses paid by a taxpayer in carrying on the taxpayer's trade or business generally may be deducted under § 162(a). However, deductions under § 162(a) are disallowed for certain illegal payments, for certain payments made in connection with a violation of antitrust laws, and "for any fine or similar penalty paid to a government for the violation of any law." § 162(c), (f) and (g). A "fine or other similar penalty" is defined in the regulations to include an amount "Paid pursuant to a conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding". Treas. Reg. § 1.162-21(b)(1). However, compensatory damages paid to a government do not constitute a fine or penalty. Treas. Reg. § 1.162-21(b)(2). If a "payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible)," deductibility depends upon "which purpose the payment was designed to serve." Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff'd, 850 F.2d 611 (9<sup>th</sup> Cir. 1988). For example, in Waldman, the court held that a criminal restitution payment was nondeductible under § 162(f) because the payments were made in satisfaction of the taxpayer's criminal liability to the state, even where the payments were made directly to victims as compensation for their injury.

Uncompensated losses sustained by a taxpayer during the taxable year may be deductible under § 165(a). For a loss to be deductible by an individual, the loss must (1) be incurred in the taxpayer's trade or business; (2) be incurred in a transaction entered into for profit; or (3) arise from a casualty or theft. § 165(c). If a taxpayer illegally obtains funds in one year and repays the funds as restitution in a subsequent year, the taxpayer may be entitled to a deduction upon repayment under § 165(a),

assuming the taxpayer included the amount in income when received. Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990); Yerkie v. Commissioner, 67 T.C. 388 (1976). In the case of a taxpayer who illegally obtains funds as a result of a transaction entered into for profit, rather than as a result of that taxpayer's individual trade or business activity, the deduction would be allowed under § 165(a) and (c)(2). See, e.g., Stephens, supra; Yerkie, supra; O'Hagan v. Commissioner, T.C. Memo. 1995-409. Such deductions are miscellaneous itemized deductions allowed only to the extent that the total of the deductions exceeds 2 percent of the taxpayer's adjusted gross income. § 67(a) and (b).

This letter has called your attention to certain general principles of the law, and does not apply the law to your particular situation. It is intended for informational purposes only and does not constitute a ruling. See sec. 2.04 of Rev. Proc. 2008-1, 2008-1 IRB 7. If you have any additional questions, please contact our office at .

Sincerely,

Thomas D. Moffitt  
Chief, Branch 2  
Associate Chief Counsel  
(Income Tax & Accounting)

cc: