Dear

This responds to your request dated July 30, 2007, submitted on behalf of the Taxpayer, requesting a ruling that the restitution payments made by Taxpayer to insurance companies for settlement of claims against the Taxpayer for insurance fraud are deductible as losses incurred in a trade or business under § 165(c)(1) of the Internal Revenue Code (Code) or alternatively as losses incurred in a transaction entered into for profit under §165(c)(2).

FACTS

The Taxpayer was a physician practicing through his professional corporation (Corporation) from Year 1 to Year 3. Corporation is an S corporation which passed through all items of income and deductions to Taxpayer on a K-1 form each year. Taxpayer included the income from the Corporation on his personal income tax returns. The income received from Taxpayer’s practice was
derived primarily from payments from insurance companies for the Taxpayer’s patients’ health care claims.

Taxpayer was indicted for insurance fraud committed from the period of Year 2 to Year 3 and was accused of knowingly making false or misleading statements of material fact or of causing false or misleading statements to be made or of omission of material information on claims made to health insurance companies. Taxpayer was indicted and pleaded guilty to such charges pursuant to a settlement agreement with the State of New Jersey. In the settlement of this matter, it was agreed that Taxpayer would pay $x dollars to New Jersey as a criminal penalty and would serve a period of incarceration. The Taxpayer paid said penalty and was incarcerated in County Jail in

Taxpayer agreed to provide restitution in the amount of $y dollars to the insurance companies to which the fraudulent claims were submitted. Taxpayer personally made the required payments to the insurance companies in _______. No part of the restitution was paid to a government entity.

Taxpayer was the sole owner and shareholder of Corporation during all relevant taxable years. During these years the entire net income of Corporation, including all amounts obtained by defrauding the insurance companies, was reported by Taxpayer on his personal income tax returns.

ISSUE

Whether a restitution payment made to insurance companies made as part of a criminal plea agreement is deductible as a loss incurred in a trade or business under § 165(c)(1) of the Code or, alternatively, as a loss incurred in a transaction entered into for profit under §165(c)(2).

LAW AND ANALYSIS

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) specifies that in the case of an individual, this deduction is limited to (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) certain losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

The repayment of fraudulently obtained funds is not deductible under § 165(c)(1). Kraft v. Commissioner, 991 F.2d 292, 298 (6th Cir. 1993); Mannette v. Commissioner, 69 T.C. 990, 992 (1978); Wusich v. Commissioner, 35 T.C. 279, 287 (1960).
Accordingly, taxpayer is not entitled to a deduction under § 165(c)(1) for the restitution he paid to the insurance companies.

Taxpayers that repay embezzled funds are ordinarily entitled to a deduction under § 165(c)(2) in the year in which the funds are repaid. Stephens v. Commissioner, 905 F.2d 667 (2nd Cir. 1990). Indeed, Rev. Rul. 65-254, 1965-2 C.B. 50, holds that a deduction is allowable under section 165 with respect to the repayment of embezzled funds by the embezzler for the taxable year in which the repayment is made. A similar result was reached in Rev. Rul. 82-74, 1982-1 C.B. 110, which holds that a convicted arsonist is entitled to a loss deduction under section 165 for repayment to an insurance company for restitution in the taxable year of repayment to the extent the proceeds were previously included in gross income. In short, payments in the nature of restitution are deductible under § 165(c)(2).

The fact that a payment is denominated as “restitution” does not necessarily qualify it as a restitution payment deductible under § 165(c)(2). For example, a deduction is not permitted where the payments are made in satisfaction of criminal liability to the state even if the payments are described as restitution. Kraft v. U.S., 991 F.2d 292 (6th Cir. 1993); Waldman v. Commissioner, 88 T.C. 1384 (1987), aff’d 850 F.2d 611 (9th Cir. 1988); see also Bailey v. Commissioner, 756 F.2d 44 (6th Cir. 1985) (where a restitution payment connected with a sentence was disallowed as a deduction even though the [taxpayer’s] fine was applied as restitution in a settlement of a multidistrict class action then pending against the taxpayer’s corporation and its officers). In Waldman the court noted that where a payment serves both a law enforcement function and a compensatory function it must be determined which purpose the payment was designed to serve (emphasis added). The Waldman court looked to state law to make this determination and concluded that the payment was not deductible as they were in satisfaction of a criminal liability.

The restitution payment at issue in this case was made pursuant to New Jersey law. Under New Jersey law, the court shall sentence a defendant to pay restitution in addition to a sentence of imprisonment or probation that may be imposed if (1) the victim suffered a loss and (2) the defendant is able to pay. N.J.S.A. 2C:44-2.b. The Supreme Court of New Jersey has said that “fines” are payments to punish the wrongdoer and to deter conduct that causes social harm and that “restitution” serves to rehabilitate the wrongdoer and to compensate the victims of the wrongdoer’s conduct. State v. Newman, 132 N.J. 159, 167-69 (1993); State v. Harris, 70 N.J. 586, 592-93 (1993). The Newman case stated that restitution, strictly defined, requires repayment to the victim of the fruits of the crime. Newman at 168. In 1991, New Jersey’s Criminal Code was amended to clarify that a “purpose of the criminal code sentencing provisions is to promote restitution to victims.” Id. at 175. Newman also note that historically, restitution’s characteristic function has been to compensate those who have suffered injuries resulting from another’s wrongful conduct and that restitution in the criminal law was generally anticipated to provide the same remedy that it did in the civil law, and to
reduce the obstacles that a victim confronts in the civil law in trying to obtain that remedy. Id. at 176. Furthermore, in New Jersey “restitution is not technically punishment for a crime. Although restitution has aspects of rehabilitation and deterrence, which are also aspects of punishment, it is predominantly nonpenal in nature.” State v. Rhoda, 206 N.J. Super. 584, 590 (1986). In addition, restitution aids in the correction of the offender and thus is rehabilitative and is part of the resocialization process. Id. at 591, 595. Thus, under New Jersey law, restitution is primarily compensatory in nature with the goal of compensating the victim for his loss and as such is deductible under § 165(c)(2). See Stephens, 905 F.2d 667 (2d Cir. 1990).

CONCLUSION

Taxpayer may deduct the amounts he paid in restitution to the insurance companies in on his federal income tax return for under § 165(c)(2) but not under § 165(c)(1).

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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,

John P. Moriarty
Chief, Branch 1
(Income Tax & Accounting)