

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Date:  
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TY:

LEGEND:

Taxpayer A:

Taxpayer B:

Taxpayers: Taxpayer A and Taxpayer B

Minority Owner C:

Minority Owner D:

Insurance Company:

Practice Entity G:

Practice Entity H:

\$J:

\$K:

\$R:

\$S:

\$T:

AA%:

BB%:

CC%:

DD%:

EE%:

FF%:

GG%:

Year 1:

Year 2:

Year 3:

Year 4:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

Date 7:

Date 8:

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

This is in response to the letter sent by your attorneys dated Date 1. In the letter, your attorneys requested that the IRS rule that (1) the \$J Taxpayer A paid to Insurance Company in Year 3 is deductible as a loss incurred in a trade or business under section 165(c)(1) of the Internal Revenue Code (“Code”) in the year paid, and that (2) the \$K

Taxpayer A paid to the Insurance Company in Year 4 will be deductible as a loss incurred in a trade or business under section 165(c)(1) in the year paid.

## FACTS

The Taxpayers are physicians who practiced medicine under several professional entities, including Practice Entity G and Practice Entity H. When Practice Entity G, a limited liability company, was formed on Date 2, Taxpayer A owned AA% and Minority Owner C owned BB% of Practice Entity G. At some point later not specified in the Taxpayers' submission, Taxpayer B became a member of Practice Entity G with a CC% ownership interest. Taxpayer A's ownership fell to CC% and Minority Owner C continued to own BB%. Taxpayers currently practice under Practice Entity H. When Practice Entity H, also a limited liability company, was formed on Date 3, Taxpayer A owned DD% of Practice Entity H, Taxpayer B owned EE% and Minority Owner D owned FF%. Minority Owner D subsequently left the practice. After Minority Owner D's departure until Date 4, Taxpayer A owned FF% and Taxpayer B owned GG% of Practice Entity H. On Date 5, Taxpayer B became an employee of Practice Entity H and thus Taxpayer A came into ownership of 100% of Practice Entity H.

In Year 1, the Insurance Company sued the Taxpayers, Minority Owner C, and Practice Entities A and B for insurance fraud, demanding both compensatory and punitive damages. On Date 6, the parties entered into a settlement agreement in which the defendants agreed to pay \$J by Date 7 and \$R in monthly installments of \$S beginning on Date 8. Included in the \$J was \$T of unpaid legitimate bills for patient services due to Practice Entity G (at that point entirely owned by Taxpayer A) that the Insurance Company was refusing to pay until the parties settled the litigation. In exchange for the payment, the Insurance Company agreed to release its claim for restitution in a then pending criminal action. The agreement stated that each defendant "shall be individually responsible for any and all payments due under this Agreement." Taxpayer A paid the balance of the \$J less the \$T to the Insurance Company in Year 3. In Year 4, Taxpayer A and Taxpayer B each paid \$K to the Insurance Company, equal to the \$R due under the settlement agreement. Minority Owners C and D paid no amounts due under the settlement agreement.

Taxpayer A has represented (a) that he previously included in his gross income in prior tax years the amounts he now seeks to deduct and (b) that he and all other defendants in [both] lawsuits are jointly and severally liable for the amounts due under the settlement agreement because the language of the settlement agreement imposes joint liability upon the defendants and New Jersey law imposes joint and several liability upon members of a limited liability company.

## LAW AND ANALYSIS

Deductions are a matter of legislative grace and a taxpayer must satisfy the specific statutory requirements of the deductions claimed. Indopco, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Deputy v. du Pont, 308 U.S. 488 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). Taxpayers bear the burden of proving entitlement to the deductions they claim. Welch v. Helvering, 290 U.S. 111 (1933).

Section 162(a) of the Code and section 1.162-1(a) of the Income Tax Regulations (“regulations”) allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 165 states that taxpayers may deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise. In the case of an individual, the deduction under section 165 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) losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from casualty or theft.

The repayment of fraudulently obtained funds is not deductible under section 165(c)(1). Kraft v. United States, 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, the Taxpayers are not entitled to a deduction under section 165(c)(1) for the restitution they paid to the Insurance Company. However, Taxpayers that repay embezzled funds are ordinarily entitled to a deduction under section 165(c)(2) in the year in which the funds are repaid. Stephens v. Commissioner, 905 F.2d 667 (2nd Cir. 1990). 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 section 165(c)(2).

Courts will typically give effect to the express tax characterization of a settlement payment by the parties to a settlement agreement. Thus, the parties’ characterization of the payment, rather than the character of the original claims to which the settlement payment relates, determines the deductibility of such payments. Middle Atlantic Distributors Inc. v. Commissioner, 72 T.C. 1136, 1145 (1979), acq. 1980-1 C.B. 1; Grossman & Sons, Inc., 48 T.C. 15, 29 (1967); Rev. Rul. 80-334, 1980-2 C.B. 61.

Taxpayer A has represented that under New Jersey law, members of a limited liability company are jointly and severally liable for the payment of damages awarded in civil suits. The Insurance Company released its claim for restitution in the criminal suit in exchange for the Taxpayers’ settlement payment. Thus, the settlement payment was restitution. As stated above, payments for restitution are deductible under section 165(c)(2). Therefore, Taxpayer A may deduct the portions of the damage award he

actually paid to the Insurance Company as losses under section 165(c)(2) provided he received no contribution from any other party and included the amounts in his gross income in prior tax years. See Rev. Rul. 82-74, 1982-1 C.B. 110.

## CONCLUSION

We conclude that Taxpayer A may deduct the payments he made to the Insurance Company in the years the payments were made, provided that he received or will receive no contribution from any other party and included the amounts he paid in his gross income in prior tax years.

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

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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,

Christopher F. Kane  
Chief, Branch 3  
(Income Tax & Accounting)

cc: