Office of Chief Counsel
Internal Revenue Service
memorandum

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to: GARY A. BENFORD
AREA COUNSEL
SMALL BUSINESS/SELF-EMPLOYED: AREA 6

from: John Aramburu
Senior Counsel, Branch 5
(Income Tax and Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

In response to your July 25, 2003, request for legal advice, we have reviewed your memorandum regarding whether the taxpayer had income from discharge of indebtedness and whether this income is excludable under § 108 of the Internal Revenue Code.

ISSUE

Whether, as a result of an obligation to make a restitution payment, the Taxpayer realized income that may be considered discharge of indebtedness income.

CONCLUSION

The discharge of the restitution obligation is not a discharge of indebtedness within the meaning of §§ 61(a)(12) or 108. Because there is no discharge of indebtedness income, whether a deduction for the restitution payment would be allowable under § 162 or another provision of the Code and the applicability of § 108(e)(2) is moot. However, because you specifically asked whether the income is subject to the deduction exception under § 108(e)(2) of the Code, a general analysis of that issue is provided below.

FACTS

(the Corporation) is owned and controlled by its sole shareholder, (the Taxpayer), who is the president of the corporation.

The United States Department of Energy (DOE) determined that in and the Corporation had violated layering regulations that generally impose price controls on resales of crude oil. In , DOE ordered restitution of the overcharges in the amount of $ plus interest. The order held the Taxpayer jointly and severally liable for the Corporation's violation.

In , the Federal Energy Regulatory Commission (FERC) reviewed and affirmed the DOE remedial order.

In , the United States District Court for the reviewed the FERC decision and entered a Final Judgment against the Corporation and the Taxpayer requiring them to disgorge as restitution the sum of $ plus interest, as provided in the DOE remedial order. The FERC and the District Court decisions were affirmed in , and a writ of certiorari was refused by the Supreme Court in .

In , DOE released its judgment lien against the Taxpayer and issued a Form 1099-C, Cancellation of Debt, to the Taxpayer in the amount of $ (the principal amount of the judgment plus interest to that date).

Examination determined that this amount was income to the Taxpayer pursuant to § 61 of the Code.

You believe that upon DOE's issuance of the Form 1099-C and release of the judgment lien, the Taxpayer realized income that may be considered discharge of indebtedness income. However, you ask whether the income is subject to the deduction exception under § 108(e)(2) of the Code.

LAW

Section 61 of the Code provides that gross income includes all income from whatever source derived, including income from discharge of indebtedness. See § 61(a)(12).

Section 108(e)(2) of the Code provides that no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

ANALYSIS

ISSUE 1: Whether the Taxpayer has discharge of indebtedness income.

The Taxpayer alleges that the liability for restitution of the overcharges resulted from transactions that benefited the Corporation and that discharge of such an obligation does not result in taxable income to him.

Generally, when a taxpayer receives funds tax free because of the obligation to repay, the debtor must report income in the taxable year in which the obligation to repay is cancelled because the debtor has realized an accession to wealth and should be taxed accordingly. See United States v. Kirby Lumber Co., 284 U.S. 1, (1931), later codified in § 61(a)(12). In Kirby Lumber, the Supreme Court held that if a corporation repurchases its own bonds for an amount less than the issue price then the difference between the issue price and the repurchase price constitutes taxable income to the corporation. The Court based its decision on the theory that a reduction in liabilities makes available a corresponding amount of assets, and this adjustment to the balance sheet constitutes gross income.

Not all discharges of indebtedness must be included in gross income. Courts have held that the application of the Kirby Lumber rules should not result in the realization of income upon the release of the taxpayer's obligation as a guarantor. For example, in Hunt v. Commissioner, T.C.M. 1990-248, the Tax Court explained:

> The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. The guarantor obtains nothing except perhaps a taxable consideration for his promise. Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over what it would have been if the original transaction never occurred. This real increase in wealth may be properly taxable [under Kirby]. However where the guarantor is relieved of his contingent liability, . . . no previously untaxed accretion in assets thereby results in an increase of net worth. Payment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, pro tanto, from being decreased. The guarantor no more realizes income from the transaction that [sic] he would if a tornado, bearing down on his home and threatening loss, changes course and leaves the house intact.

Hunt v. Commissioner, T.C. Memo. 1990-248 (citing Landreth v. Commissioner, 50 T.C. 803, 812-813 (1968), acq., 1969-2 C.B. xxiv (citations omitted).

Similar to the present case, in Whitmer v. Commissioner, T.C. Memo 1996-83, the taxpayer formed a wholly-owned corporation, Midwest Agencies, Inc. (Midwest). Midwest sold insurance products on a commission basis and entered into an agreement with ITT Life Insurance Corp. (ITT). Under the agreement, when an insurance agent sold a policy, he received from ITT a commission that approximated the total commissions that would be earned over the life of the policy (including renewals). The unearned portion of each commission was considered a loan. If the policy lapsed or was canceled, the portion of the commission remaining unearned on the policy was treated as a liability of Midwest. When ITT, Midwest and the taxpayer terminated their business relationship, ITT filed suit against Midwest for repayment of advance commissions. The taxpayer was named as a defendant because he guaranteed all of Midwest's obligations to ITT. Midwest and the taxpayer filed a counterclaim, and the parties settled the litigation by signing a mutual release.

The Service determined that the taxpayer realized discharge of indebtedness income. The Tax Court ruled against the Service stating:

> Midwest obtained a nontaxable increase in assets on account of its debt to ITT. The taxpayer did not. To be sure, the taxpayer intended as Midwest's sole shareholder to derive some benefit from the arrangement with ITT. The hard fact remains, however, that the commissions and the loan proceeds that were the subject of the debt went to Midwest, and they did not go into taxpayer's pocket. ITT's forgiveness of its debt to Midwest also did not increase taxpayer's net worth. It merely prevented petitioner's net worth from being decreased.

Id. at 12.

In the present case, according to your memorandum, the Taxpayer had personal control of the operations of the Corporation and participated in the transactions in which the overcharges occurred. He was the only one with authority to conduct such trades. In addition, you state that a review of transcripts of the Taxpayer's account for the years through indicates that the Taxpayer did not have sufficient reported income to generate $, but that the Taxpayer has admitted to taking approximately $ offshore at about the same time as the Corporation's overcharges. Consequently, under the central figure liability theory, you conclude, in accordance with DOE's earlier determination, that the Taxpayer personally benefited from the overcharges . However, in accordance with the preceding case law, if the Taxpayer did not personally benefit from the overcharges, his role is, in substance, that of a guarantor on the obligation, and the discharge of the obligation does not result in taxable income to the Taxpayer.[1]

We have not found any case law or guidance directly on point. However, evaluating the present transaction in its entirety, even if the Taxpayer actually received the $, this amount was in all likelihood income to the Taxpayer that should have been taxed at that time. Unlike the typical § 108 situation in which a taxpayer receives nontaxable loan proceeds and a discharge of indebtedness leads to an increase in the debtor's assets, in this case, income is not realized upon the discharge of the restitution

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1 The need to limit any discharge of indebtedness income to the extent to which the Taxpayer benefited from the overcharges is illustrated by a hypothetical discharge of both the Taxpayer and the Corporation. Unless the income of the joint obligors is limited, cancellation of a single amount would result in double the amount of income. See Significant Service Center Advice 1998039, (April 1, 1998).

obligation because the original receipt of the $ already increased the Taxpayer's net worth. Consequently, the discharge of the restitution payment did not increase the Taxpayer's net worth, but merely prevented the Taxpayer's net worth from being decreased. Thus, we believe the discharge is not a discharge of indebtedness within the meaning of §§ 61(a)(12) or 108.

ISSUE 2: Whether the Taxpayer's restitution payment would be deductible under § 162(a).

Section 162(a) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-21(b)(1) of the Income Tax Regulations provides that a fine or similar penalty includes an amount "(ii) paid as a civil penalty imposed by Federal, State, or local law," or "(iii) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal). . . ". Section 1.162-21(b)(2) provides in relevant part that "compensatory damages. . . paid to a government do not constitute a fine or penalty."

Section 1.162-1(a) provides that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. It is well settled that expenses paid by a taxpayer on behalf of another person, without pertaining to the taxpayer's trade or business, are not deductible by the taxpayer under § 162(a). See, e.g., Welch v. Helvering, 290 U.S. 111 (1933); Ihrig v. Commissioner, 26 T.C. 73, 75-76 (1956); Ludwig v. Commissioner, T.C. Memo 1994-518. However, expenses made on behalf of another person are deductible under § 162(a) when the payment is connected with a trade or business of the taxpayer. See, e.g., Gould v. Commissioner, 64 T.C. 132, 134-136 (1975).

In the Taxpayer's case, whether any payments pursuant to the remedial order would have been deductible under § 162(a) by the Taxpayer depends in part upon the Taxpayer's reasons for any payment he might have made. There is no indication in the facts as to the Taxpayer's basis for his claim of the § 162(a) deduction. The following is a general discussion of the legal rules that are applicable.

In Ludwig, the taxpayer was the sole shareholder of a corporation that was liquidated in 1988. In 1989, the Department of Labor (DOL) sued both the corporation and the taxpayer for unpaid overtime on behalf of the corporation's former employees. The DOL alleged that the taxpayer was the alter ego of the corporation and therefore personally liable to pay the overtime. The taxpayer settled with the DOL and paid an amount designated as overtime wages. The judgment provided that the payment was in settlement of the taxpayer's personal liability for the alleged failure of the corporation to pay the claimed overtime wages. The taxpayer and his spouse deducted the amount of the settlement payment on their 1990 Schedule C ("Profit or Loss from Business"). During 1990, the corporation was no longer in business, and the taxpayer worked as an employee of another company.

The Ludwig court held that the settlement paid by the taxpayer in satisfaction of the judgment was not deductible by the taxpayer under § 162(a). The court said that although the taxpayer was the president and sole shareholder of the corporation, "the business of the corporation may plainly not be treated as the trade or business of [the taxpayer], himself, a distinction which has been recognized in a long line of cases . . . ." It was not material to the analysis under § 162(a) that the taxpayer was personally liable for the judgment.

Ludwig is factually distinguishable from Gould. In Gould, the taxpayer was allowed a deduction under § 162(a) for his payment of expenses incurred by his wholly owned corporation, GPH. The taxpayer was an employee, director, and minority shareholder of another corporation in the same field, IMC. When GPH began to have financial difficulties and to fail, its creditors grew concerned about its inability to make payments. IMC's directors became concerned that GPH's financial condition might adversely affect IMC because of IMC's association with the taxpayer. The court found as a fact that the taxpayer believed that his employment with IMC would be terminated unless he settled GPH's affairs satisfactorily. The court held that payments made by the taxpayer to satisfy the creditors of GPH were deductible by the taxpayer under § 162(a), because they were made in expectation of continued receipt of earnings from his employment at IMC.

In allowing the taxpayer the deduction, the Gould court drew a distinction between payments made by the taxpayer to protect his employment with IMC, and payments made by the taxpayer to revitalize GPH or to protect his investment in IMC. The court indicated that while the former were deductible in the taxpayer's trade or business as an employee of IMC, the latter would be non-deductible contributions to the capital of GPH or IMC.

The Taxpayer's trade or business, as a corporate officer and sole shareholder of the Corporation, was not the Corporation's trade or business. Expenses that the Corporation would be entitled to deduct under § 162(a) are not ordinarily deductible under § 162(a) by the Taxpayer as an individual, either in his capacity as corporate officer, employee, or shareholder of the Corporation, regardless of his legal obligation to make the payments. Ihrig at 76; Ludwig at 6. Therefore, generally, the Taxpayer would not be entitled to a deduction under § 162(a) for payments pursuant to the remedial order, even if the Corporation was entitled to a § 162(a) deduction for the same payment. If, however, the Taxpayer had made payments pursuant to the remedial order for a reason connected with or pertaining to his trade or business when the payment was made, the payment would be deductible under § 162(a) as an ordinary and necessary business expense of the Taxpayer, under Gould.

Because there is no indication in the facts we have regarding the Taxpayer's motive, in the (hypothetical) event he had made payments pursuant to the remedial order, we think it is likely that Gould does not apply, and that the Taxpayer would not be allowed a deduction under § 162(a). In general, taxpayers must prove their entitlement to § 162(a) deductions. Whipple v. Commissioner, 373 U.S. 193, 201-202 (1963); Gould at 136-137. If the Taxpayer has facts to indicate that Gould, or similar cases, would have applied, then the deduction probably would have been allowed under § 162(a), subject to possible disallowance by § 162(f).

ISSUE 3: Whether § 162(f) would have barred a deduction for the restitution payment made by the Taxpayer pursuant to the remedial order.

Section 162(f) disallows a deduction for civil penalties that are imposed for the purpose of enforcing the law or as punishment for violation of the law. However, a civil payment may be deductible if it is imposed to encourage compliance with the law or as a remedial measure to compensate another party. See, e.g., Waldman v. Commissioner, 88 T.C. 1384, 1387, aff'd, 850 F. 2d. 611 (9th Cir. 1988). Where a payment could serve both punitive and compensatory purposes, it is necessary to determine which purpose the payment was designed to serve. S & B Restaurant, Inc. v. Commissioner, 73 T.C. 1226, 1232 (1980); Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136, 1145 (1979); Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 31 (1967).

The characterization of a payment for purposes of § 162(f) depends on the origin of the liability giving rise to the payment. Middle Atlantic Distributors, Inc., 72 T.C. at 1144-45. The origin of a settlement payment would generally be the original claims to which the payment relates. Adolf Meller Co. v. United States., 600 F. 2d. 1360, 1363-64 (Cl. Ct. 1979). However, courts will typically give effect to the express characterization of a settlement payment by the parties to a settlement agreement. See, e.g., Grossman & Sons, Inc., 48 T.C. at 29; Rev. Rul. 80-334, 1980-2 C.B. 61.

In the Taxpayer's case, FERC stated that the Taxpayer's joint and several liability for restitution was not a penalty as against the Taxpayer. In addition, DOE's method of obtaining restitution for violations of the layering regulations is through remedial orders, and you indicated that there is nothing in the remedial order to indicate that the restitution was intended to be a penalty. These factors suggest that the restitution for violating the layering provisions may be intended to be remedial rather than punitive, and intended to encourage compliance with the law. Thus, unless there is evidence to indicate otherwise, we do not think that § 162(f) would have barred the deduction.

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Please call if you have any further questions.