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TY:

Chapter 7 Bankruptcy Estate	=
Dr. A	=
Dr. B	=
Orthopaedic Clinic	=
City	=
State	=
Statute	=
Statute Section	=
Year 1	=
Year 2	=
Year 3	=
Year 7	=
Year 9	=
a	=
b	=
c	=
d	=

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

This is in response to your letter dated February 28, 2000, on behalf of Chapter 7 Bankruptcy Estate, requesting a ruling on the proper tax treatment of certain interim or final claims paid under §§ 1398 and 162 of the Internal Revenue Code. The information submitted for consideration is summarized below.

FACTS

Dr. A practiced orthopaedics in City, State. In Year 1, Dr. A entered into an agreement to sell the assets of his medical practice, Orthopaedic Clinic, to Dr. B. The parties signed an Asset Purchase Agreement which contained a restrictive covenant prohibiting Dr. A from practicing orthopaedics within a certain geographic area for a three-year period following the execution of the Asset Purchase Agreement. The parties also entered into a non-solicitation agreement, under which Dr. A agreed to refrain from soliciting former patients and contacts, as well as former employees, in a manner which would interfere with Dr. B's practice. Finally, the parties entered into a Provider Agreement, under which Dr. A would continue practicing with Dr. B for a period of one year and would be paid a percentage of his billings as a salary. Such practice of medicine by Dr. A was excepted from the terms of the restrictive covenant and the non-solicitation agreement. (The parties also entered into a lease for the medical offices and several other agreements which are not at issue in this ruling request.)

Dr. A continued to practice medicine with Dr. B for over two years after the sale of the orthopaedics practice. The doctors informally extended the term of the provider agreement and also increased the amount of Dr. A's compensation. During the Spring of Year 3, a dispute arose between the doctors concerning Dr. A's compensation. They were unable to resolve the dispute, and Dr. A allegedly began violating the terms of the non-solicitation agreement and restrictive covenant by practicing orthopaedics on his own behalf and interfering with Dr. B's practice. Dr. B also asserted that Dr. A failed to refer patients to him, converted his money and property, and interfered with his practice of orthopaedics. Dr. A claimed that Dr. B had failed to properly compensate him for work beginning in February of Year 2. All of the parties' disputes arose from their post-sale professional relationship. The disputes ended up in arbitration, and the arbitrators entered an award against Dr. A in the following amounts:

Fees received for medical procedures (Collections received by Dr. A for services rendered by Dr. A from 2/1/Year 3 - 6/1/Year 3)	$ a
Breach of Provider Agreement (for Dr. A's failure to refer knee and shoulder cases to Dr. B)	$ b
Violation of Restrictive Covenant (Dr. A practiced orthopaedics on his own behalf); and Violation of Non-solicitation Agreement (Dr. A solicited former employees to work for him, solicited and treated former patients)	$ c
Tortious interference with Dr. B's medical practice	$ d
Conversion of Dr. B's money and property (Receivables from patients)	$ e
Total damages awarded to Dr. B	$ f
Attorney fees awarded to Dr. B	$ g
Arbitrator's fees awarded to Dr. B	$ h
Total compensatory award	$ i
Interest on award through date of filing bankruptcy petition	$ j

Punitive damages	$ k
Total due to Dr. B to arbitration award	$ l
Less amount due to Dr. A for unpaid compensation	$ (m)
Net amount due to Dr. B	$ n

The arbitration award was entered as of May 13, Year 3. Dr. A filed a petition in bankruptcy on October 3, Year 7, and died in November of Year 9, while the bankruptcy case was pending. The Trustee in bankruptcy is considering making an interim payment to the creditors of the estate, including Dr. B. The Trustee seeks a ruling on the issue of whether any interim or final distribution to Dr. B to pay the above amounts is deductible under §§ 162 and 1398.

ISSUE

Whether all or any portion of the $ n due to Dr. B pursuant to the arbitration award outlined above is deductible under §§ 1398 and 162 of the Internal Revenue Code.

CONCLUSION

Sections 1398(e)(3) and 162(a) allow deduction for the total amount outlined above as ordinary and necessary business expenses, with the exception of the $ e attributable to the conversion claim and a pro rata amount of interest. The $ e attributable to the conversion claim may be deductible under § 165(c) as a loss if Dr. A included this amount in income for the taxable year in which it was received.

DISCUSSION

Section 1398 applies, with certain exceptions, to any case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual. Section 1398(a). Section 1398(e)(3) provides that the determination of whether any amount paid or incurred by a bankruptcy estate is allowable as a deduction or credit shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and business, and in the activities, the debtor was engaged in before the commencement of the bankruptcy case.

Section 162(a) allows a deduction for “all the necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” Section 1.162-1(a) of the Income Tax Regulations provides the general rule that deductible business expenses include the “ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business . . . ." Therefore, an expense must be ordinary and necessary and have the requisite relationship to the taxpayer's business in order to be deductible under § 162(a).

I. Compensatory Damages Portion of Arbitration Award

A. Fees for Medical Procedures, Breach of Provider Agreement, Violations of Restrictive Covenant and Non-solicitation Agreement, and Tortious Interference

The determination of whether a litigation or settlement expense is deductible under § 162(a) depends on the "origin and character of the claim" with respect to which the expense was incurred, rather than the potential consequences to the taxpayer's assets. Commissioner v. Tellier, 383 U.S. 687, 6898 (1966); United States v. Gilmore, 372 U.S. 39, 49 (1963); Ostrom v. Commissioner, 77 T.C. 608, 613 (1981).

> [T]he "origin-of-the-claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. . . . Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.

Boagni v. Commissioner, 59 T.C. 708, 713 (1973).

In Graphic Business Systems, T.C. Memo 1982-167, three employees of Arnold Graphics, a manufacturer and retailer of business forms, left the company to form their own business, Graphic Business Systems. Arnold filed suit against the three employees and Graphic for unfair competition, improper recruiting of Arnold's former employees, improper use of Arnold's sales data and customer records, and improper solicitation of business from Arnold's customers. Graphic settled the lawsuit, and then deducted the settlement payment under § 162(a). The court applied the origin of the claim analysis, and held that all of the claims arose from Graphic's business activities–operation of a business that competed with Arnold's business, recruitment of Arnold's former employees, use of Arnold's sales data and customer records, and solicitation of business from Arnold's customers. The origin was Graphic's business activities even though many of the acts complained of were accomplished by the three former employees and the three former employees were named as individual defendants in the lawsuit. The court noted that, since the "gravamen" of Arnold's suit was based on the operation of Graphic's business, the relationship of the settlement fees to Graphic's business was not affected by whether Graphic's three major shareholders could have been held separately liable on Arnold's claims.

Other decisions have concluded that settlements or other litigation expenses arising from an employee's intentional or fraudulent conduct are deductible under § 162(a) if they otherwise meet the origin of the claim test. See, e.g., O'Malley v. Commissioner, 91 T.C. 352 (1988)(legal fees incurred to defend trustee of pension plan fund accused of conspiracy to bribe a Senator, where underlying activities were related to trusteeship position); Ostrom v. Commissioner, 77 T.C. 608 (1981)(payment of judgment for president and general manager of a plumbing company's fraudulent misrepresentations concerning the company's financial status); Musgrave v. Commissioner, T.C. Memo 1997-19 (payment to settle lawsuit after employee embezzled from a client).

In the instant case, Dr. A was engaged in the trade or business of practicing medicine for the two years after the sale of Orthopaedic Clinic to Dr. B. Each of Dr. B's claims arose from Dr. A's activities in practicing orthopaedics during the Spring of Year 3. Dr. B claimed that: (1) Dr. A failed to refer knee and shoulder cases to Dr. B; (2) Dr. A practiced orthopaedics for his own benefit when he was supposed to be practicing medicine on Dr. B's behalf; (3) Dr. A wrongfully solicited Dr. B's employees and patients; (4) Dr. A interfered with Dr. B's orthopaedics practice; and (5) Dr. A improperly kept all of the receivables from patients he treated. Because all of Dr. A's activities arose from his practice of medicine, payment of the compensatory damages portion of the arbitration award entered against Dr. A is an ordinary and necessary expense arising from these business activities. It matters not that Dr. has died. Under § 1398(e)(3), these expenses are deductible by the bankruptcy estate, which is that of an individual debtor under chapter 7 of title 11 of the United States Code, as though they were paid or incurred by Dr. A and as if Dr. A were still engaged in his trade or business.

Litigation expenses incurred in connection with claims involving the acquisition or disposition of capital assets are not automatically deductible under § 162(a). Such expenses are capital and must be added to the taxpayer's basis in the assets in question. See, e.g., Redwood Empire Sav. & Loan Assn v. Commissioner, 628 F.2d 516 (9th Cir. 1980)(attorneys' fees and settlement payment arising from defense of a suit for fraud in connection with the purchase of real property); Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970)(payment to settle lawsuit filed by prospective buyer for specific performance of an asset purchase agreement of a closely-held corporation); Boagni v. Commissioner, 59 T.C. 708 (1973) (legal fees incurred in declaratory judgment action to determine title to overriding royalty interests are capital expenditures because the title to real property is at issue; legal fees incurred in an interpleader-type action filed by oil company asking court to determine how proceeds from oil and gas lease should be distributed are deductible).

This rule does not apply to the instant situation, even though the first event in the fact pattern was the sale of Dr. A's medical practice, a capital transaction. The claims themselves did not arise from the capital transaction. Dr. B did not, for example, seek specific performance or recission of the asset purchase agreement. The claims submitted to arbitration arose from Dr. A's practice of medicine over two years later and his violations of the ancillary agreements: (1) the restrictive covenant; (2) the non-solicitation agreement; and (3) the parties' post-sale working relationship. Because the instant claims arose from Dr. A's business of practicing medicine, the compensatory portion of the award entered is deductible by the estate under §§ 162(a) and 1398(e)(3).

B. Conversion

The compensatory damage portion of the arbitration award includes $ e on Dr. B's conversion claim, for monies and property of Dr. B taken over by Dr. A. It is not clear from the award, or from the other documents submitted by the taxpayer, whether this constitutes an award of money to compensate Dr. B for the money and property taken by Dr. A, or whether it constitutes a return of the converted property (money). If this amount constitutes a compensatory award, then it is also deductible under §§ 162(a) and 1398(e)(3) for the reasons outlined above, because it arose from Dr. A's business of practicing medicine.

If, however, this amount constitutes a return, or restitution of the converted property, it may be deductible as a loss under § 165(c). A taxpayer who repays embezzled or converted funds is entitled to a deduction in the year of repayment so long as the same amount was included in income for the taxable year in which the funds or property were received. Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990); Yerkie v. Commissioner, 67 T.C. 388 (1976). See also Spitz v. Commissioner, 432 F. Supp. 148 (E.D. Wis. 1977) (deduction for repayment of embezzled funds not prohibited by § 162(f)). Thus, the $ e repayment for conversion is deductible under §§ 165(c) and 1398(e)(3) if Dr. A included $ e for property or funds received in income for the taxable year of receipt.

II. Attorneys' and Arbitrator's Fees

The rationale discussed in section I(A) above also applies to the portion of the arbitration award requiring Dr. A to reimburse Dr. B for Dr. B's legal and arbitration fees. That is, a payment for this portion of the award is deductible because it arose from the same underlying facts as the claims for damages: Dr. A's business of practicing orthopaedics. See, e.g., O'Malley v. Commissioner, 91 T.C. 352 (1988), Musgrave v. Commissioner, T.C. Memo 1997-19, and Graphic Business Systems, Inc. v. Commissioner, T.C. Memo 1982-167 (all allowing a deduction for attorneys' fees and costs arising from the taxpayers' business activities).

III. Interest

Interest on a civil damages award is deductible in situations where the underlying award is deductible as an ordinary and necessary business expense. Keane v. Commissioner, T.C. Memo 1998-116; Musgrave v. Commissioner, T.C. Memo 1997-19.

Thus, to the extent the underlying award constitutes an ordinary and necessary business expense, interest on that amount is also deductible.[1]

III. Punitive Damages

The arbitrators entered a punitive damages award in the amount of $ k for Dr. A's violation of the State punitive damages Statute. This statute provides for an award of punitive damages in tort actions if a defendant's actions show "willful misconduct, malice, fraud, wantonness, oppression, or that entire want of care which would raise the presumption of conscious indifference to consequences." Statute Section.

Section 162(f) provides that "no deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." In Rev. Rul. 80-211, 1980-2 C.B. 57, the Service held that punitive damages paid by a corporation to another private litigant in a civil suit are deductible as ordinary and necessary business expenses if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. In Rev. Rul. 80-211, the taxpayer was sued by another corporation for fraudulent acts and contractual violations perpetuated in the ordinary course of its business activities. Because the underlying acts were undertaken in the ordinary course of business, and the deduction of payments of punitive damages to another private citizen is not specifically prohibited by [then] § 162(c), the Service held that such a payment is deductible under § 162(a). [The former subsection (c) under § 162 is now subsection (f).]

In the instant case, the conduct underlying the award of punitive damages is the same as the conduct underlying Dr. B's other claims: Dr. A's activities in practicing orthopaedics during the Spring of Year 3. Because these activities were undertaken in the ordinary course of Dr. A's business of practicing medicine, the punitive damages award based on the same conduct is also deductible by the estate under §§ 162(a) and 1398(e)(3).

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Michael D. Finley
Chief, Branch 3
Income Tax & Accounting

cc: Director

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[1] If Dr. A did not include the $ e worth of converted property in income in the year of receipt, rendering the payment of this portion of the arbitration award nondeductible, then a pro rata portion of the interest is also nondeductible.