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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Payment by Employer in a Subsequent Year of Amounts for Additional FICA and Withholding Taxes Due from Employees in Earlier Years is Deductible under I.R.C. § 162 as an Ordinary and Necessary Business Expense

This Field Service Advice responds to your request dated November 20, 1999. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUE:

Whether Taxpayer's payment of an amount determined to be due upon an audit of earlier taxable years and representing its employees' portion of additional withholding and FICA taxes on certain meal allowances is deductible as an ordinary and necessary business expense under section 162.

CONCLUSION:

Taxpayer's payment of an amount determined to be due upon an audit of earlier taxable years and representing its employees' portion of additional withholding and FICA taxes on certain meal allowances is deductible as an ordinary and necessary business expense under section 162, irrespective of whether the amounts paid in that later year constitute income to the employees.

FACTS:

As the result of an employment tax audit, Taxpayer was assessed FICA taxes, income tax withholding, and backup withholding (plus penalties) on certain meal allowances it had paid to its employees earlier in Years 1 through 3. The audit determined that such meal allowances had constituted additional compensation and were taxable as such when paid to the employees. Taxpayer paid the payroll taxes assessment in full in Year 4. It never sought any recompense from its employees for the amounts representing the employees' putative "share" of the total. In Year 5, Taxpayer filed an income tax refund claim, asserting the deduction of the above-described additional amounts assessed and paid in Year 4. The Service disallowed that claim to the extent it included any amount originally "due" from employees. You have concluded their position is correct and ask for our advice. We disagree.

LAW AND ANALYSIS:

Section 162(a) allows a deduction for any "ordinary and necessary" business expense. This does not mean that an expense must be unavoidable to be deductible, only that it be "appropriate and helpful." Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Welch v. Helvering, 290 U.S. 111, 113 (1933). An expense need not be habitual or common to be deductible. Id. at 114.

Reasonable direct compensation to employees in the form of salaries, wages, or bonuses is deductible within such meaning; yet, compensation is not, of course, the only deductible ordinary and necessary expense a taxpayer might incur. In brief, notwithstanding the respondent's position upheld in L & L Marine Service, Inc. v. Commissioner, T.C. Memo. 1987-426, we believe the more correct view is to allow the deduction of the post-audit amount of the employees' share of the FICA and withholding taxes that was not paid over in the earlier year by the employer where no recompense by those employees was sought by that employer.

Section 275(a), which expressly bars the deduction of certain taxes–including the employees' share of FICA and wages withholding--seems merely a red herring in this context. The Taxpayer here is not deducting the tax paid by someone else or, indeed, really any tax per se; rather, Taxpayer is paying over an amount that would have been due from its employees as a tax and, in deference to its relations with those employees, has chosen not to seek recompense from them.[1] Section 275 necessarily presumes that the deductibility-barred tax is in fact a tax on the entity that is seeking the deduction. See S. Rep. No. 830, 88th Cong., 2d Sess., at 56 (1964); H.R. Rep. No. 749, 88th Cong., 1st Sess., at 50 (1963). Paying the taxes due from another--for appropriate business reasons–does not run into the section 275 bar. We note also that the revenue rulings discussed below did not invoke section 275 at all with respect to the payment of employees shares; thus, Service position can be assumed to be that section 275 is inapplicable in that area. See also Rev. Proc. 81-48, 1981-2 C.B. 623; Rev. Rul. 74-75, 1974-1 C.B. 19 (neither citing section 275 as a concern).

Expenses incurred for the benefit of another are not deductible under section 162 unless the taxpayer has actually paid those expenses for the taxpayer's own proximate benefit in connection with their own trade or business. See Austin Co. v. Commissioner, 71 T.C. 955, 967 (1979), acq., 1979-2 C.B. 1. Thus, a bank may deduct state taxes imposed upon a depositor which the bank has paid for that depositor, Rev. Rul. 77-418, 1977-2 C.B. 61, and "[a]ssuming that it is otherwise appropriate" an employer may deduct the payment of an employees' FICA tax as an ordinary and necessary business expense under section 162, Rev. Rul. 86-14, 1986-1 C.B. 304, at 305 Situation 1. It could be argued, for that matter, that the latter revenue ruling has actually already conceded the issue in the instant case. The only distinction is that the tax amount paid there was actually bargained for and paid in the year in issue. Taxpayer would likely discount such matters as immaterial to the inherent concession made by the ruling. In any resulting litigation, such an argument would be difficult to counter. See also PLR 8635004 (section 162 deduction for payment of employees share allowed in a later year notwithstanding absence of any express agreement); PLR 8437008 (deduction allowed for taxpayer's voluntary payment of income taxes, to preserve customer relations, originally due from recipients of promotional trips taxpayer had awarded).

In the case before us, this proximate benefit to Taxpayer is rather apparent. The expense benefitted the general employee/employer relationship–not so much because Taxpayer in fact paid the amounts–but because it obviously saved the Taxpayer from the negative consequences likely to result if it had not. It seems fair to say that those employees would be less than receptive to paying any "tax" for

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[1] The Service provides a comprehensive definition of what constitutes a "tax" in Rev. Rul. 57-345, 1957-2 C.B. 132, and Rev. Rul. 70-622, 1970-2 C.B. 41.

which they were no longer legally liable just so their employer would not be denied an income tax deduction because of some nuance of the Internal Revenue Code.[2] With respect to those workers who had since left Taxpayer's employ, the ability to collect and the willingness to pay is even more unlikely. While the argument could be made that this situation could have been avoided had the Taxpayer simply paid the employees' shares in the first place–as the L & L Marine opinion expressly asserts–we are unsure that particular test should be endorsed. Presumably many taxpayers end up paying more "later" for their earlier actions or inaction during the course of carrying on a business. Section 162 does not impose a "but for" test upon deductibility of expenses; consequently, absent any assertion that the payments here were inherently unreasonable in amount,[3] against public policy,[4] or otherwise barred, we should not hold this Taxpayer to a different standard.

Your incoming request's discussion as well as the Explanation of Items by the revenue agent correctly rely upon L & L Marine Service, Inc. v. Commissioner, T.C. Memo. 1987-426, as supporting the legal conclusion that the expenditures in issue here--an employer paying its employees' share of payroll taxes–is neither an ordinary or necessary business expense of that employer under section 162. L & L

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[2] In this regard it should be noted that nothing contained herein should be construed as an interpretation of the Code's employment tax provisions, including what, if any, continuing tax obligations exist for the employees or reporting requirements remain for the employer. See, e.g., Treas. Reg. § 31.6051-1(c)(1). For income tax purposes only, it seems unlikely those years remain open at all for the employees.

[3] See Commissioner v. Heininger, 320 U.S. 467 (1943), aff'g 133 F.2d 567 (7th Cir. 1943), rev'g 47 B.T.A. 95 (1942).

[4] See section 162(f) prohibiting a deduction of fines and penalties. Public policy concerns also seem to be the notion at the root of the denial of the deduction in Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943), rehearing denied, 320 U.S. 809 (1943), cited by the L & L Marine opinion, as well as you and the field agent for the proposition that a legal obligation to pay--standing alone--is inadequate to support income tax deductibility. While that tenet is essentially unassailable, it does not materially aid the determination here because it may be equally asserted that the lack of an underlying legal liability does not necessarily preclude a section 162 deduction. Champion Spark Plug Co. v. Commissioner, 30 T.C. 295, 298 (1958), aff'd per curiam, 266 F.2d 347 (3d Cir. 1959). There are other considerations involved. In the Interstate case the taxpayer was attempting to deduct the expenses of another corporation–to which it was unarguably contractually obligated–for carrying on a business in which the taxpayer itself was barred by law from pursuing. The legal obligation to make the payment in that scenario should not override the fact that the taxpayer cannot–by definition--be in the business for which it claims the expense.

Marine states that the amounts in issue were primarily the responsibility of the employees, not the employer and that the "[employer-taxpayer] only became legally obligated to pay the taxes after it failed to withhold them." If that opinion were controlling, then we agree that the facts of the instant case would lead to the same result and the deduction would properly be disallowed.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

While we agree that L & L Marine may not be distinguishable on its facts from those presented here, and though it may be the only decision specifically on point, it does remain merely a memorandum opinion. We are not comfortable in relying upon the Service-favorable result reached therein, in short, because we believe that result is incorrect as a matter of law. As near as we can tell, the brief in L & L Marine was never reviewed in the National Office. There is no record of such review and no card file or copy of the brief exists for the case in our Digest Room. We would not recommend advocating the section 162 position taken there–despite the fact that it prevailed--if we were presented that case currently.

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By: _____
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