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

OFFICE OF
CHIEF COUNSEL

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Dear :

This letter responds to your request for information dated February 17, 2009.

The information you have requested involves the application of section 265(a)(1) to taxpayers who are civilian employees of the United States government and who, when filing their state income tax returns for a taxable year, must pay an amount of state income taxes that is in excess of the amount of state income tax withheld from their pay during that taxable year.

In such situations, the individual taxpayer is a civilian employee of the U.S. government, and uses the cash receipts and disbursements method of accounting (the cash method). A portion of the taxpayer's income in Tax Year 1 is attributable to a cost-of-living allowance that section 912 exempts from federal income tax. Notwithstanding the federal tax exemption, the income attributable to the allowance is subject to state income tax.

When filing his federal income tax return for Tax Year 1, the taxpayer itemizes his deductions on Schedule A and deducts the state income tax he paid in Tax Year 1 through withholding. The taxpayer adjusts the amount of his deduction for state income taxes (paid in Year 1 through withholding) to account for the disallowance provisions of section 265(a)(1), since this deduction is allocable, in part, to tax-exempt income. However, taxpayer also owes an additional amount of state income taxes, in excess of the amount withheld from his pay in Tax Year 1. He pays the additional amount of state income taxes due for Tax Year 1 in Tax Year 2, when he files his state income tax return for Tax Year 1. Since the taxpayer uses the cash method, he does not take a federal income tax deduction in Tax Year 1 for the additional state income tax he owed for Tax Year 1 but paid in Tax Year 2. Instead, the deduction for the additional state income taxes is reported on Schedule A of his federal income tax return filed for Tax Year 2, the year in which he paid the additional amount.

Section 912 provides that cost of living allowances received by civilian employees stationed in certain areas, including the state in question here, are not subject to federal income tax. Section 164 provides for the deduction of state or local taxes paid during the taxable year. Section 265(a)(1) generally disallows deductions for any amount otherwise allowable as a deduction that is allocable to income (other than interest) that is wholly exempt from federal tax.

Rev. Rul. 74-140, 1974-1 C.B. 50, dealt with the situation of a civilian employee of the U.S. government who was stationed in Hawaii and who received a cost-of-living allowance that was wholly exempt from tax under section 912. In that revenue ruling, the Service held that the portion of the state income taxes allocable to the tax-exempt income was nondeductible under section 265.

The issue is virtually the same here. The only difference is that, as a result of underwithholding of state income taxes, a portion of the taxpayer's state income tax that is attributable to Tax Year 1 was paid in Tax Year 2. Thus, since the taxpayer uses the cash method, the amount of state income taxes due for Tax Year 1 that was paid in Tax Year 2 is deductible in Tax Year 2. Accordingly, when taxpayer files his federal income return for Tax Year 2 and deducts the additional state income tax payment, he must also account for the portion of the additional payment that was allocable to the tax-exempt cost-of-living allowance. The issue is, when determining the amount of the additional state income tax payment that is nondeductible under section 265(a)(1), what ratio of tax-exempt income to total income should be used to determine the portion of the Tax Year 2 payment that is allocable to tax-exempt income: that of Tax Year 1, when the tax-exempt income that it relates to was received, or that of Tax Year 2?

We conclude that the portion of the state income tax payment made in Tax Year 2 that is allocable to tax-exempt income received in Tax Year 1, and thus the amount that is non-deductible by virtue of section 265, should be determined based on the ratio of the tax-exempt income to the total income in Tax Year 1. This conclusion is based on our reading of the statute and regulations.

The regulations under section 265(a)(1) provide, in pertinent part, as follows:

> *Allocation of expenses to a class or classes of exempt income.* Expenses and amounts otherwise allowable which are directly allocable to any class of classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto.

Treas. Reg. Section 1.265-1(c).

The regulations clearly state that the expenses allocable to the tax-exempt income should be "allocated thereto." The tax-exempt income at issue was received in Tax Year 1. Therefore, the additional payment made in Tax Year 2 should be allocated to the class of tax-exempt income included in Tax Year 1, and the determination of the nondeductible portion should be based on the ratio of tax-exempt to total income in that year.

We also note that a taxpayer who received a cost of living allowance in Tax Year 1 may not receive such an allowance in Tax Year 2, either because no such benefit was bestowed in Tax Year 2 or because the taxpayer was no longer working for the government or earning income in Tax Year 2. Thus, if the disallowance was based on the ratio of tax-exempt to total income in Tax Year 2, a taxpayer receiving no tax-exempt income in Tax Year 2 would not be subject to a disallowance of a portion of the deduction for the state tax payment made in Tax Year 2, even though a portion of the deduction is allocable to tax-exempt income. Thus, the only basis for determining the nondeductible portion of the state tax payment in Tax Year 2 at issue here is by allocating it according to the amount of tax-exempt income received in Tax Year 1.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2005-1, §2.04, 2005-1 IRB 7 (Jan. 3, 2005). If you have any additional questions, please contact our office at .

Sincerely,

Jeffery G. Mitchell
Chief, Branch 6
(Income Tax & Accounting)