

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Gary Renville, Governmental Liaison for California

from: Neal Abreu
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SBSE:7:SAC:1

subject: Deductibility of 2 ½% Additional Tax under California Rev. & Tax. Code § 17085

Issue:

Whether the 2 ½% additional tax imposed by California Rev. & Tax. Code § 17085 is deductible as a tax under I.R.C. § 164.

Answer:

Yes

Facts and Discussion:

I.R.C. section 72(t) imposes a 10-percent additional tax on early distributions from qualified retirement plans (subject to certain exceptions). Although we sometimes loosely refer to this as a penalty, it is clearly an income tax as reflected by the heading to the subsection which states that it is a "10-percent additional tax." Indeed, section 72(t)(1), titled "Imposition of Additional Tax," provides specifically that a taxpayer's tax under "this chapter" (i.e., Chapter 1, Normal Taxes and Surtaxes) shall be increased by an amount equal to 10% of the portion of the distribution which is includible in gross income.

Part 10 of Division 2 of the California Rev. & Tax. Code (sections 17100 et seq) imposes an income tax in California patterned largely after the Internal Revenue Code. In the 1980s, the Revenue and Taxation Code was substantially revised. The revised

law now incorporates the Internal Revenue Code unless otherwise specifically provided. California Rev. & Tax. Code § 17024.5.

Sections 17081, et seq. of the California Rev. & Tax. Code govern the computation of gross income in California. The provisions of I.R.C. section 72 apply in the calculation of gross income except as modified by section 17085 of the California Rev. & Tax. Code. In particular, section 17085(c) imposes a "penalty" of 2 1/2 percent (in lieu of the 10% amount imposed in the Internal Revenue Code). Although the word "penalty" is used, it is readily apparent from the structure of the California Rev. & Tax. Code (i.e., the placement of section 17085 in the article defining gross income) that it should be considered a component of tax. In fact, those items which we normally consider to be penalties (i.e., late filing penalties, accuracy penalties and the like) are included in an altogether different part of the California Rev. & Tax. Code, sections 19131, et seq.

Since it is apparent that the 2 ½ % additional amount is properly considered a tax, it is deductible under I.R.C. § 164. This advice has been coordinated with the office of the Associate Chief Counsel, Income Tax and Accounting which concurs in our conclusion.

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