



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

March 20, 2002

OFFICE OF
CHIEF COUNSEL

Number: **200225030**
Release Date: 6/21/2002

CC:ITA:2
SCANO-111622-02
UIL: 164.03-00

MEMORANDUM FOR STEPHEN DETILLIAN
CHIEF, AAB QUALITY ASSURANCE SECTION
BECKLEY FINANCE CENTER

FROM: Heather Maloy by Thomas Moffitt
Associate Chief Counsel
(Income Tax & Accounting)

SUBJECT: Service Center Advice

This Service Center Advice responds to your request for information dated February 5, 2002.

ISSUE

Whether an employee may claim a deduction for state income taxes under § 164 of the Internal Revenue Code with respect to payments to a state made by the employer to satisfy the employee's state income tax liabilities for previous years, where the employer treats the payments as wages paid to the employee.

CONCLUSION

Under these circumstances, the employee is treated as having made the payments of the state income taxes, and may claim an itemized deduction for the payment on Schedule A of Form 1040 for the year the payment is made.

FACTS

For several years an employer has reimbursed its employees for nondeductible expenses incurred in its trade or business. Section 1.62-2 of the Income Tax Regulations indicates that these payments should have been treated as payments of wages, subject to federal and state income tax withholding, but the employer did not treat these amounts as wages. The employer has since learned that it had been out of tax compliance, and it has begun treating these payments as taxable wages.

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In order to bring itself and its employees into compliance for prior taxable years, the employer paid amounts to the federal government and to state governments representing what it determined were the taxes that would have been payable by its employees for all open taxable years. The employer also included as wages in each employee's Form W-2 the amounts paid to the federal and state governments on the employee's behalf, based on Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

DISCUSSION

Section 164(a)(3) allows an individual to deduct state and local, and foreign, income, war profits, and excess profits taxes in determining federal taxable income for the taxable year in which the taxes are paid. However, the deduction is allowable only if the individual itemizes deductions. See § 63.

When the employer paid the employees' state back taxes, it treated the payments as taxable to the employees under principles set forth in the Old Colony Trust case. In that case, the Supreme Court found that an employer's payment of the employee's federal and state income tax liabilities represented additional compensation to the employee. In other words, the employer's payment of the employee's taxes was treated as a payment of compensation to the employee followed by the employee's payment of federal and state income taxes. Accordingly, an employee who itemizes deductions for federal income tax purposes should be entitled to a state income tax deduction for the payment under § 164.

Because the payment of state back taxes is not a payment of current state taxes, the payment should not be included in box 17 (state income tax) of Form W-2 for the current year.

Example:

In taxable year 2001 Employee Jones, a resident of State A, earned \$30,000 in salary, and her employer also paid \$5,000 in back taxes (\$4,000 federal, \$1000 state) related to prior taxable years. On Jones' Form W-2, the employer reported \$35,000 as wages. Pursuant to State A's withholding rules, the employer withheld \$1,750 in state income taxes for taxable year 2001, based on the \$35,000 wage amount, and reported the withheld amount in box 17 (state income tax) of the Form W-2.

When Jones files her federal income tax return for 2001, she may deduct, as itemized deductions, both the \$1,750 state income tax withheld from 2001 wages as well as the \$1,000 paid for the State A back tax liabilities.

If you need further information, please call (202) 622-7900.