Private Letter Ruling 8742010

Jul. 10, 1987

This is in reply to your letter dated May 6, 1986, as supplemented by letters dated June 20, 1986, July 22, 1986, and August 29, 1986, concerning the deductibility under the Internal Revenue Code of payments made by the above-named Taxpayer pursuant to the State A revenue statute.

Taxpayer, an accrual basis taxpayer, is engaged in the business of distributing X.

During the year 1985, the State A legislature enacted legislation providing to Y a credit against state income taxes for the installation of Z. The credit applies to only the first $5000 of actually installed Z per unit. The credit allowed in each of the first two tax years in which the credit is claimed is ten percent of the certified cost of Z but can not exceed the tax liability of the taxpayer. The credit allowed in each of the succeeding three years is five percent of the certified cost, but can not exceed the tax liability of the taxpayer. A credit which is not used by the taxpayer in a particular year may be carried forward and offset against the taxpayer's tax liability for the three succeeding tax years but may not be carried forward for any tax year thereafter.

To facilitate payment of the credit to Y, State A has provided a procedure for Taxpayer to pay the present value of such credit to Y. Taxpayer is then entitled to apply the face amount of the credit as an offset against its state excise tax liability in the proportions and over the period specified in the State A revenue statute.

Taxpayer has suggested that its payments to Y for tax credits may be deductible as taxes under section 164 of the Code. Section 164(a)(3) allows a deduction for state income taxes.

A tax has been defined as an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes. Rev. Rul. 61-152, 1961-2 C.B. 42. In the present case, Taxpayer has convinced us that it is forced by state laws and regulations to purchase the tax credits from Y. Taxpayer has not shown, however, that the taxing power of the state is in any way involved. Moreover, Taxpayer has not shown that there is a purpose to raise revenue involved.

In VIRGINIA NATIONAL BANK V. UNITED STATES, 321 F. Supp. 316 (E.D. Virginia 1970), the court held that a bank could deduct payments to exempt shareholders that were equal to the amount of state tax that would have been levied on them had the state taxed their interests as it did those of non-exempt shareholders. The court allowed the deduction under section 162, but stated for the record that a deduction also would be allowable under section 164. There, however, the payment to the exempt shareholders was required by the same taxing statute which required the bank to pay a tax on its shareholders. In the instant case, by contrast, the effective purchase of Y's tax credits is found in the “Z” part of the State A statutes, and not the “Revenue and Taxation” part of the State A statutes. A further distinction is that in VIRGINIA NATIONAL BANK the court noted that prior to a 1964 law change, the payments to exempt institutions could be made to the State Treasurer, who would remit them to the exempt

institutions. The analogous situation here would be if Taxpayer formerly paid a tax to the state which was earmarked for Z, which the state then paid over the Y. That fact pattern does not exist in this case.

In Rev. Rul. 71-49, 1971-1 C.B. 103, a state law provided that a cooperative housing corporation holding a leasehold or other non-title interest in property owned by a state educational construction fund was exempt from real property tax, but was instead required to make payment to the fund of annual or other periodic amounts equal to the amount of real property taxes that would otherwise have been paid. The Rev. Rul. holds that these tax equivalency payments are real estate taxes allowable as a deduction under section 164. The rationale of the Rev. Rul. is that while ordinarily amounts paid into a specific fund are treated as imposed as a regulatory measure or charge for a privilege or service, the tax equivalency payments in the Rev. Rul. could not be so treated. The Rev. Rul. states that these payments were charges imposed on the cooperative housing corporation in order to obtain revenue the city would otherwise have lost because of its treatment of the fund as a tax-exempt public benefit corporation. The Rev. Rul. notes that the tax equivalency payments were measured by and were equal to the amounts imposed by the regular taxing statutes and were themselves imposed by specific state statute. Although the payments went directly to the fund instead of the state's general revenue fund, they were nevertheless designated for a public purpose rather than for some privilege, service or regulatory function or for some other local benefit tending to increase the value of the property upon which payments were made.

The situation in Rev. Rul. 71-49 differs from the present case because in the Rev. Rul. payments are made to the government, which in that case is the city. In the instant case, Taxpayer, in purchasing tax credits of Y, is not making a payment to the government; instead it is making a payment directly to Y. We understand that a public purpose for these payments exists, i.e., to promote Z. We cannot, however, recast the transaction to deem that Taxpayer made these payments to the state which, in turn, paid them over to Y. Also, in the instant case, unlike Rev. Rul. 71-49, the payments by Taxpayer to Y are not measured by the amount of taxes which would otherwise be due.

Based on the above, we do not believe Taxpayer's payments are deductible as taxes under section 164. However, such payments may be deductible as ordinary and necessary business expenses under section 162.

Rev. Rul. 73-465, 1973-2 C.B. 49, involves a state retailers' and consumers' sales and use tax levied in respect of the retail purchase, retail sale, rental, storage, use or consumption of tangible personal property and specified services. The ruling holds that amounts paid to the state by retailers and dealers in lieu of collecting the tax are not deductible by them under section 164(a) of the Code, since such payments are not made as a result of the tax imposed upon such retailers and dealers, but may be deductible by them as business expenses if otherwise qualified for such treatment under section 162. Similarly, see Rev. Rul. 72-608, 1972-2 C.B. 100, and Rev. Rul. 73-91, 1973-1 C.B. 71.

Section 162(a) of the Code allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. This language requires that the expenses directly relate to the business of taxpayer. DEPUTY V. DUPONT, 308 U.S. 488, 493-494 (1940); KORNHAUSER V. UNITED STATES, 276 U.S. 145, 153 (1928). The State A program to encourage Y to employ Z is related to Taxpayer's business of providing X, in that the program will reduce consumption of X by Y, therefore making X available to other consumers.

Section 162(a) of the Code limits deductions to expenses that are "ordinary and necessary." What is ordinary is a variable affected by time, place and circumstance. WELCH V. HELVERING, 290 U.S. 111, 113-114 (1933). Each case turns on its special facts. DEPUTY V. DUPONT, 308 U.S. 488, 496 (1940). "The decisive distinctions are those of degree and not of kind." WELCH V. HELVERING, 290 U.S. 111, 114 (1933). Absent evidence that the transaction giving rise to the expenditure is of common or frequent occurrence in taxpayer's type of business, there must be a basis for an "assumption, in experience or common knowledge, that . . . payments {sought to be deducted} are to be placed in the same category as typically ordinary expenses . . . ." DEPUTY V. DUPONT, 308 U.S. 488, 495-497 (1940). Taxpayer has represented that the State A program to encourage Z, and in which Taxpayer is a participant, is customary in the X industry.

An expense is necessary if it is "appropriate and helpful." WELCH V. HELVERING, 298 U.S. 111, 113 (1933). Taxpayer's proposed payments are required by State A law in carrying on the business of supplying X.

Although we believe that Taxpayer's payments are ordinary and necessary business expenses under section 162 of the Code, under section 461 of the Code, the fact that a taxpayer has made an unconditional payment does not automatically entitle it to accrue a deduction for the full amount thereof in the year of payment. Section 1.461-1(a)(2) of the regulations requires deferral of the deduction for expenditures which result in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year.

In the instant case, Taxpayer is entitled to apply the amount of the credits as an offset against its state excise tax liability in future years. Taxpayer's right to apply the amount of the credits as an offset against its state excise tax liability is contingent only upon it having sufficient taxable income during the period in which the credits may be applied as an offset to state taxes. The likelihood that Taxpayer will not apply the credits as an offset against its future state taxes is remote. Accordingly, the amounts paid by Taxpayer to Y to acquire Y's state tax credits creates an asset within the meaning of section 1.461-1(a)(2) of the regulations. Taxpayer should be permitted a deduction for the amounts paid to Y to acquire Y's state tax credits in the years and in the proportions the credits to which the amounts paid relate are applied as an offset to state taxes.

Accordingly, based on the above, Taxpayer should be permitted a deduction for amounts paid to Y to acquire Y's state tax credits in the years and in the proportions the credits to which the amounts paid relate are applied as an offset to state taxes. To the extent the credits are applied as an offset to state taxes in futures years, Taxpayer should recognize such tax-offsets as a reduction in the deduction for state excise taxes in the years the credits are applied as an offset to state

taxes. + This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. A copy of this ruling should be attached to your federal income tax return for the year in which the transaction occurs.