Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200947035**
Release Date: 11/20/2009

CC:ITA:3: MLLam
POSTN-123462-09

UILC: 162.00-00

date: July 09, 2009

to:

from: Christopher F. Kane
Branch Chief, Branch 3, CC:ITA:3
(Income Tax & Accounting)

subject:

LEGEND

Taxpayer =

Club/Employer =

Player/Employee =

On January 16, 2009, the Office of Associate Chief Counsel (Income Tax & Accounting) issued Chief Counsel Advice (CCA) (POSTF-135262-08) concluding that Taxpayer may not take a deduction under section 162 of the Internal Revenue Code (Code) for compensation paid to Employee pursuant to an employment contract because Taxpayer was receiving disability insurance payments on account of Employee's injury and section 162 disallows a deduction for an expense for which there is a right or expectation of reimbursement. Upon further consideration, the Office of Associate Chief Counsel (Income Tax & Accounting) has concluded that Taxpayer is not precluded from taking a section 162 deduction for the compensation paid to Employee pursuant to the employment contract merely because Taxpayer received insurance payments on account of Employee's disability. Nor does section 265(a)(1) disallow such a deduction. These conclusions are based upon the facts as described in our prior CCA.

This CCA does not alter the prior CCA's conclusion that Taxpayer may exclude from gross income proceeds received under a disability insurance policy related to an injured employee under section 104(a)(3).

Section 1.162-7 of the Income Tax Regulations provides that there may be included among the ordinary and necessary expenses paid or incurred in carrying on a trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 1.162-10(a), however, specifically, limits the deduction for amounts paid or accrued as compensation for injuries to the amount not compensated for by insurance or otherwise. Amounts paid or accrued by a taxpayer on account of injuries received by employees and lump-sum amounts paid or accrued as compensation for injuries are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise[1]. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business.

Section 162(a) of the Code provides a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. To properly claim the deduction requires an expense. Indopco, Inc. v. Commissioner, 503 U.S. 79 (1992). A deduction is not allowed for an expense for which there is a right or expectation of reimbursement. This reimbursement theory is premised on either the principle that these expenditures are in the nature of loans or advancements and, as such, are not ordinary and necessary business expenses, or on the principle that the taxpayer has made no economic outlay by making the expenditure by virtue of the reimbursement. See Burnett v. Commissioner, 356 F. 2d 755 (5th Cir. 1966) cert. denied 385 U.S. 832 (1966). The application of either of these principles to deny a deduction requires a finding that the expense and the reimbursement be connected to each other. Service position and case law have dealt with the issue of just how connected the expense and the reimbursement must be in order for the right to reimbursement to have the effect of denying the section 162 deduction.

Revenue rulings that deny a section 162 deduction on this basis demonstrate that factually the expense deducted and the right to reimbursement must be such that the expense incurred must bear a close nexus to the reimbursement. In Rev. Rul. 78-388, 1978-2 C.B. 110, providing that a taxpayer's moving expenses for which the taxpayer has a fixed right of reimbursement are not deductible under section 162 or 165, the taxpayer incurred moving expenses pursuant to a taking by a state highway authority for

[1] Because Employee was not paid by Employer on account of injuries received by Employee as a lump sum amount as compensation for injuries, but was rather paid compensation pursuant to his employment contract which required that his salary be paid regardless of physical condition, this sentence does not apply to deny Taxpayer's deduction for compensation.

the interstate highway program of the premises leased by the taxpayer. The expenses were reimbursed under a federal statute that provided uniform policies for the treatment of persons displaced by federal and federally assisted programs. Both the moving expense and the reimbursement arose because of the taking and there was no reimbursement without the expense. The reimbursement provided for in the statute insured that the taxpayer would suffer nothing more than a temporary economic outlay. In Rev. Rul. 79-263, 1979-2 C.B. 82, disallowing a deduction for the portion of cattle feed expenses for which the taxpayer was to be reimbursed, the expense that arose due to disaster related loss of feed was to be explicitly reimbursed by legislation pertaining to such conditions and providing for the added cattle feed expense reimbursement. The connection between the additional cattle feed expense and the reimbursement was clear and directly provided for in the legislation. Rev. Rul. 80-348, 1980-2 C.B. 31, denies a deduction for travel expenses that are reimbursed in a subsequent year. The revenue ruling does not explicitly detail the connection between the travel expenses and the reimbursement, but Rev. Rul. 78-209, 1978-1 C.B. 25, which it modifies, indicates that the union reimburses all delegates from its local chapters to its convention for their living and travel expenses. Thus, the nexus between the living and travel expense and the reimbursement for such expenses is clear. These revenue rulings stand in contrast to Rev. Rul. 64-329, 1964-2 C.B. 58, which holds that a casualty loss deduction will not be reduced by the amount of cash gifts excluded from the recipient's income because there was no limitation or directive on how the cash gifts were to be used by the recipient. This demonstrates the lack of connection between the casualty loss and the gifts received is enough to allow the casualty loss deduction. This ruling, in turn, cites to Rev. Rul. 131, 1953-2 C.B. 112, which holds under similar circumstances that such gifts do reduce the casualty loss deduction allowed because the money received by the recipient had to be used to rehabilitate or replace the property that was the subject of the casualty. Here the nexus is complete and the gifts are a reimbursement for the loss sustained.

Case law in this area also holds that a right to reimbursement may preclude a taxpayer from deducting expenses. In Manocchio v. Commissioner, 710 F.2d 1400 (9th Cir. 1983), the appeals court found that the allowance the taxpayer received was a direct reimbursement for expenses he attempted to deduct. The amount was tied directly to the expense by a formula and the reimbursement was made at the time of the expenditure. The educational expenditure was for a flight training course and the legislation providing for reimbursement covered flight training course expenses. The connection between the expense and reimbursement was direct. The expense precipitated the reimbursement. In the Manocchio case in the Tax Court, (Manocchio v. Commissioner, 78 T.C. 989, 994 (1982)), the court describes the reimbursement situation as one where, but for the expense, there would not be a reimbursement. In Tachometer Corporation v. Commissioner, 37 T.C. 158 (1961), acq. 1962-2 C.B. 3, the taxpayer was allowed a deduction for moving expenses because the taxpayer had only a general right to reimbursement. The court concluded that although the taxpayer had a general right to reimbursement, conflicting evidence to determine the amount of compensation indicated the lack of definiteness of the taxpayer's right.

In the case at hand, Employer's expense is a salary expense pursuant to an employment contract which guarantees Employee's compensation. The payment Employer is receiving is an insurance payment under a disability insurance contract. The insurance proceeds are not required to be paid to Employee and may be used by Employer for other purposes. There is no requirement, as in Rev. Rul. 131, above, that the insurance proceeds be used to pay Employee's salary. The insurance proceeds were received by Employer as a result of Employee's disability. As such, they were excluded from Employer's income under section 104(a)(3)[2]. They were not received as a reimbursement for compensation paid to Employee, even though they may have been measured to some extent by the compensation to be paid to Employee under his employment contract. There is not a close enough nexus between the disability insurance payment and the salary expense of Employee to connect the two. This case differs from the revenue rulings where the taxpayer was reimbursed for the expense. In the rulings cited above, it is clear that if the expense is incurred, it would be reimbursed and the reimbursement depends on the expense. In situations where this nexus is not clear, the deduction has been allowed. In the case at issue here, Employer is receiving disability insurance payments under an insurance policy and paying salary payments under a separate employment contract. The right to the insurance proceeds derives from the insurance contract and the employee's disability and not from the legal obligation to make the salary payments. The connection between the expense and the payment is not such that the receipt of the insurance payment depends on the salary expense having been incurred. Because of this lack of a nexus, the insurance payment is not a reimbursement for the compensation expense.[3]

An additional reason for not applying the reimbursement theory to the case at hand is that the exclusion from gross income of the disability insurance proceeds pursuant to section 104(a)(3) is a specific exclusion enacted by Congress which should not be overridden by the general rule of section 162 that reimbursed expenses are not deductible. When Congress enacted what is now section 104(a)(3) and subsequently reenacted it in 1954 and again in 1986, Congress was aware that it applied to insurance proceeds received by employers on account of insurance policies they had taken out on their employees. Rev. Rul. 66-262, 1966-2 C.B. 105, holds that section 104(a)(3) applies to both employer corporations as well as individual employees and that section 265 denies the deduction for premiums paid for such policies. The revenue ruling cites Castner Garage, Ltd. v. Commissioner, 43 B.T.A. 1 (1940), as support for this proposition. Therefore, if there had been any doubt that this exclusion applied to

[2] It is not being contested that the insurance proceeds were received by Employer as some other type of payment than insurance payments arising on account of an employee's disability.

[3] The tax benefit rule is not applicable. Generally, the tax benefit rule requires a taxpayer who benefited from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. Since we have determined that the disability insurance payment that Employer received was not a reimbursement for payments of Employee's compensation under his employment contract, we find that there is no inconsistent event upon which to base an application of the tax benefit rule.

employers the answer was clear as early as 1940. This exclusion from gross income under section 104(a)(3) was reenacted in the 1954 Code as well as in the 1986 Code. Pursuant to the legislative re-enactment doctrine, Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt the interpretation when it re-enacts a statute without change. Lorillard v. Pons, 434 U.S. 575, 580, 98 S.Ct. 866 (1978).

Using the reimbursement theory to deny the deduction for compensation has the effect of frustrating the effect of the exclusion from gross income provided by section 104(a)(3). This is contrary to what Congress intended when it enacted section 104(a).

While section 162(a) generally precludes a taxpayer from taking a deduction for an expense when there is a right or expectation of reimbursement, section 104(a)(3) specifically excludes the disability insurance proceeds from gross income and section 265 has the effect of specifically providing that the premium expense cannot be deducted since it is "allocable to" a class of tax-exempt income other than interest. It is a well established rule that a 'specific statute controls over a general one without regard to priority of enactment.' Bulova Watch Co. v. United States, 365 U.S. 753, 758, 81 S.Ct. 864 (1961). Section 104(a)(3) and section 265 control over section 162(a) in this instance. Section 162 should not be employed in such a manner as to override the specific exclusion of section 104(a)(3).

Section 265(a)(1) of the Code provides that no deduction shall be allowed for any amount otherwise allowable as a deduction that is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Internal Revenue Code, or any amount otherwise allowable under section 212 which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

In this case, section 265 does not prohibit the deduction of the compensation payment made to Employee because the deduction is not allocable to the insurance proceeds received from the disability policy. The statute uses the term "allocable" to describe the relationship the deduction must have to the tax exempt income. This term implies a close connection between the tax exempt income and the deductible expense. Here, the compensation payment is not the reason for the insurance payment. The insurance payment is received on account of Employee's disability not on account of Employer's contractual obligation to pay Employee's salary. In Manocchio v. Commissioner, 78 T.C. 989 (1982), the Tax Court based its disallowance of an expense deduction on the application of section 265. It found that there was a close connection between the receipt of tax exempt income in that case and the claimed deduction for the education expense claimed by the taxpayer. The court reasoned that the right to reimbursement for the expense arose only when the Veterans Administration received a signed certification of the training and the cost of such training. In the court's opinion this created a fundamental nexus between the reimbursement income and the expense

which fell within the meaning of the "allocable to" language. Manocchio, 78 T.C. at 994-5. The relationship between the insurance proceeds and the compensation paid to Employee in this case is not of this caliber. The right to the insurance proceeds did not arise out of the requirement to pay Employee compensation, rather it arose from the disability incurred by Employee and is separate from the Employer's requirement to pay compensation under the compensation agreement. With no connection between the income and the expense, the requirement that the expense be allocable to the tax exempt income is not met, and section 265 does not disallow the deduction.

Please call us at (202) 622-4950 if you have any questions about this memorandum.