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TAX MATTERS

## IRS bound to honor designation of voluntary payment by one taxpayer of another's liability

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In a reviewed opinion, the Tax Court held that the IRS must follow a corporation's designation of voluntary payments toward the income tax liabilities of its owners/employees. However, because the payments did not represent taxes withheld at the source, the IRS was allowed to levy on the assets of the owners/employees to collect applicable interest and penalties. Likewise, the corporation remained liable for interest and penalties attributable to its failure to remit taxes on a timely basis.

[Sec. 3402](#) requires employers to withhold taxes from wages paid to employees. [Sec. 31\(a\)](#) provides employees with a credit against their income tax for amounts withheld at the source. Under [Regs. Sec. 1.31-1\(a\)](#), this credit is applied to the calendar year of the withholding without regard to whether or when the employer remits the tax. Tax of an employee is deemed to have been withheld at the source only if the employer (1) contemporaneously withholds tax in the correct amount or (2) corrects a withholding error by making a timely and proper adjustment.

[Rev. Proc. 2002-26](#) allows a taxpayer to designate how voluntary partial payments are applied against liabilities of tax, penalties, and interest. If a taxpayer does not make a designation, the IRS generally applies payments to tax, penalties, and interest, in that order. Likewise, the IRS generally honors designations of voluntary payments between different types of taxes, such as corporate income or employment tax obligations. When a tax is divisible, such as employment taxes that relate to specific employees and calendar quarters, case law has held that a taxpayer may designate and pay a divisible portion of the total tax obligation. [Sec. 6331\(i\)\(1\)](#) prohibits a levy against a taxpayer with respect to an unpaid divisible tax during pending legal proceedings.

James and Sharon Dixon served as officers and employees of Tryco, a temporary staffing business they founded in 1990. At first, Tryco was a great success, and the Dixons paid themselves generously. In late 1992, however, Tryco stopped filing and remitting employment taxes, and the Dixons stopped filing individual income tax returns. In 1997, the Dixons were criminally prosecuted for failure to file individual income tax returns for 1992 through 1995, and as part of a settlement that resulted in a reduced sentence, they agreed to make restitution to the IRS for its tax loss in the amount of \$61,021. In 1999, the Dixons contributed this amount to Tryco, and Tryco then submitted it to the IRS, accompanied by a cover letter indicating that the payment represented Tryco's withholding taxes to be applied to the withheld income taxes of the Dixons.

In 2000, when accountants prepared the individual income tax returns for the Dixons' missing years, they determined that the couple owed \$30,202 more in taxes than Tryco had previously submitted to the IRS. As before, the Dixons contributed this amount to Tryco, and the corporation in turn submitted it to the IRS with a cover letter indicating that the payment represented the Dixons' withheld income taxes. On the advice of legal counsel, the Dixons chose not to pay their individual income tax liabilities directly, believing that the indirect payments through Tryco would reduce both the portion of the company's withholding tax liability attributable to themselves and their own income tax liabilities. They also hoped to avoid interest and penalties on the payments by availing themselves of [Sec. 31's](#) crediting scheme, which treats withholding at the source as paid in the year of the withholding irrespective of the employer's date of remittance.

The IRS initially credited Tryco's payments to the Dixons' 1992–95 income tax liabilities, which discharged their tax

obligations but not the applicable interest and penalties. Later, the IRS reversed itself and applied the payments to Tryco's general unpaid employment tax liabilities, which then exceeded \$23 million. The IRS then issued a notice to the Dixons of intent to levy on their assets in satisfaction of their now unpaid 1992–95 income tax liabilities. The Dixons petitioned the Tax Court for review.

The Dixons contended first that they were entitled to a withholding credit under Sec. 31 for the amounts submitted by Tryco on their behalf in 1999 and 2000. Second, they asserted that the IRS was obligated to honor Tryco's designation of the payments as withheld income taxes and to credit the amounts toward the Dixons' 1992–95 income tax liabilities.

The IRS argued that its policy of honoring designations of voluntary payments is confined to particular tax periods or types of tax. It contended that the policy does not extend to designations of delinquent employment tax by one party toward the income tax liability of another.

Both the majority and dissenting opinions of the court concluded that the funds submitted by Tryco to the IRS in 1999 and 2000 were not withheld at the source and, accordingly, that the Dixons were not entitled to a Sec. 31 credit against their individual income tax liabilities. Regarding the Dixons' second argument, the majority determined that the IRS was obligated to follow its published administrative position regarding designations of voluntary payments. The IRS was therefore directed to properly credit the \$91,223 payments to the Dixons' account, fully discharging their 1992–95 income tax obligations. The IRS was allowed, however, to levy on the Dixons' assets to collect applicable interest and penalties. Tryco likewise remained liable for interest and penalties.

■ [Dixon](#), 141 T.C. No. 3 (2013); related decision at [Dixon](#), T.C. Memo. 2013-207

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