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INCOME TAX AND ACCOUNTING

National Director, Tax Forms and Publications Division PC:FP

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Retroactive Refunds of State Income Tax

This is in response to your request for technical assistance which was prompted by the recent court decisions concerning the taxation of federal pensions by various states. Affected states are now paying tax refunds based on the state income taxes which had been paid on federal pensions. These refunds are being paid in the form of cash or credit vouchers. You have raised a number of issues pertaining to the federal tax treatment of the state tax refunds, and we address these issues below.

First, you ask whether these state income tax refunds are subject to the recovery rules under section 111 of the Internal Revenue Code. The recovery rules under section 111 are part of what is known as the tax benefit rule. The tax benefit rule has an exclusionary component and an inclusionary component. Together these components provide that a recovery, including a refund of state taxes, is subject to the tax benefit rule only if a federal income tax deduction was taken in a prior year for the amount that has been recovered. The exclusionary component of the rule is set forth in section 111 and excludes from gross income the recovery of any amount deducted in a prior year if the deduction did not result in a federal income tax benefit. The inclusionary component of the rule has been developed through case law and provides that gross income includes the recovery of any amount deducted in a prior year if the deduction resulted in a tax benefit. Accordingly, a refund of state taxes will not be subject to the tax benefit rule, nor includible in gross income, if in a prior year the taxpayer did not take a deduction for state taxes paid or to the extent a deduction did not result in a tax benefit to the taxpayer.[1]

Second, you ask whether the interest received on state tax refunds is fully taxable under section 61 of the Code. In general, interest paid to an individual on a state tax refund is includible in income for federal tax purposes. This is true whether or not the taxpayer realized a tax benefit from deducting the refunded tax in a prior year.

Third, if a state tax refund and interest are paid in the form of a credit voucher, and the refund, or a portion thereof, is includible in income under the tax benefit rule, you question whether the amount includible in gross income is limited to the amount of the voucher that is actually used to offset state income taxes in the tax year that the amount is used. An alternative would be to include in gross income the full amount of the voucher in the tax year that the taxpayer receives the voucher. Under normal circumstances, when a taxpayer is due a refund for state income taxes that have been overpaid (through withholding or otherwise), the taxpayer may choose to either receive the refund immediately, usually in cash, or in the future as a credit against future taxes. Because the taxpayer exercises control over whether or not to receive the refund immediately, even if the taxpayer chooses to have the refund credited in a later year, the taxpayer would be considered to have constructively received income in the year the state admits its liability and the taxpayer makes the choice (assuming, of course, that the taxpayer has realized a tax benefit in a prior year from a deduction for state income taxes paid).

The circumstance at hand is different because the taxpayers who are entitled to vouchers do not have control over whether to receive their refunds immediately in the form of cash or as a voucher. Hence, the taxpayer who is only entitled to a voucher will not have constructively received the full amount of the voucher in the year the state admits its liability. Instead, assuming the taxpayer uses the cash method of accounting, the taxpayer should include in gross income the amount of the voucher that is actually used to offset state income taxes in the tax year that the amount is so used. For example, if one-half of a total voucher is used in 1996 to offset a 1995 state income tax liability, the taxpayer should report one-half of the total voucher as income for 1996.

[1] Although credits and exclusions from income may also produce tax benefits, they will not be at issue with respect to state income taxes paid and recovered by federal pensioners.

Your fourth question pertains to the technical accuracy of the Table 5 worksheet, previously found in IRS Publication 525. Table 5 provides a means for determining the taxable amount of a recovery of a deduction taken before 1987. Upon review, we conclude that the worksheet is technically accurate and reflects the tax law in the relevant years.

Table 5 is designed to figure the tax benefit of an itemized deduction taken in a year when the zero bracket amount (ZBA) was in effect. The ZBA did not reduce adjusted gross income in arriving at taxable income; rather, the ZBA was made a part of the tax rate schedule, whereby the zero (tax rate) bracket amount was the first income bracket in the schedule. Taxpayers were permitted to deduct on their returns an amount called "excess itemized deductions" which was equal to the excess of a taxpayer's total itemized deductions over the ZBA appropriate for that taxpayer.[2]

Table 5 outlines an initial step for determining the tax benefit of a deduction taken prior to 1987, which is merely to list "excess itemized deductions" from the prior year. The taxpayer is considered to have experienced, at most, a tax benefit to the extent the taxpayer's total itemized deductions exceeded the ZBA.

A subsequent step in the tax benefit analysis requires the taxpayer to examine taxable income to determine if the amount computed in the initial step truly represents a prior year tax benefit to the taxpayer. Table 5 provides in part that if taxable income was less than the ZBA, the tentative tax benefit listed in the initial step, or "excess itemized deductions," should be reduced by the excess of the ZBA over taxable income. This is because there is no tax benefit from an itemized deduction to the extent taxable income would not otherwise have been taxed due to the ZBA. We believe that all of the computations outlined in Table 5 are still technically accurate, and the table can be relied upon for a proper computation of the tax benefit for years prior to 1987.

Lastly, you ask whether a period of limitation issue arises under Chapter 66 of the Code, considering that refunds will be paid for tax years as early as 1983. When a taxpayer recovers an amount properly deducted in a prior tax year, a period of limitation issue does not arise. A

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[2] The standard deduction replaced the ZBA pursuant to the 1986 Tax Reform Act. The standard deduction is incorporated in the worksheet for determining the taxable amount of a recovery of a deduction taken after 1986.

recovery is only significant as an item of gross income in the year it is recovered. If an itemized deduction was proper in the year taken, the taxpayer cannot amend the prior year return to include the recovery as income or to delete the deduction. Therefore, it does not matter if the prior year is closed due to a period of limitation since income and deductions do not change in that year.[3]

We hope this information is helpful to you. If you have additional questions, contact Judith A. Lintz at 622-4940.

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(signed) RUDOLF M PLANERT
By ______________________
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[3] The Tax Court has recognized an "erroneous deduction exception," holding that the tax benefit rule cannot be applied to require the inclusion of recovered amounts in income if they were erroneously allowed as deductions in a year which is closed. Canelo v. Commissioner, 53 T.C. 217 (1969). The Service published its nonacquiescence with this conclusion in 1982. Canelo, Nonacq., 1982-1 C.B. 1.

Because it is the position of the Service to apply the tax benefit rule even when recovered amounts were improperly deducted, all recovered amounts should be treated the same so that the period of limitation will never be an issue. Nevertheless, with respect to the refund of state income taxes paid on federal pensions, if a deduction was taken for state taxes in the year of payment, it is unlikely that the deduction was improper.

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