Cross References
• Rev. Rul. 2019-11

If a taxpayer receives a federal tax benefit from deducting state and local taxes, and in the following year the taxpayer receives a refund of all or a portion of those state taxes, a portion of the refund may be subject to federal income tax in the year the refund is received.

The issue is further complicated with the new $10,000 limit under the Tax Cuts and Jobs Act (TCJA). For tax years starting in 2018, the itemized deduction for taxes paid is limited to $10,000 ($5,000 MFS) for the aggregate of:

1) State and local property taxes not paid or accrued in carrying on a trade or business, or an activity related to the production of income (rental real estate activities), and
2) State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income taxes, etc.) paid or accrued in the tax year.

It is this $10,000 limit under TCJA and the various situations that may apply that is the subject of a recent IRS revenue ruling. If a taxpayer pays only the proper amount of state and local tax in the prior year, then itemized deductions for that year may either be lower, or the taxpayer may have opted for the standard deduction. The taxpayer must determine in each situation the amount of itemized deductions (or standard deduction) that the taxpayer would have deducted in the prior year had the taxpayer paid only the proper amount of state tax. The taxpayer must then compare this amount to the total itemized deductions actually taken, or the standard deduction that could have been taken, and include the difference as income on the current year return if the taxpayer received a tax benefit in the prior tax year from that itemized deduction.

Assume that in the following examples, all of the taxpayers are single and itemize deductions on their federal income tax returns for 2018 in lieu of using the standard deduction of $12,000. The taxpayers did not pay or accrue the taxes in carrying on a trade or business or an activity for the production of income. Also assume that the taxpayers were not subject to AMT and were not entitled to any credit against income tax. Each taxpayer uses the cash method of accounting for reporting income and deducting expenses.
Example #1
Amy paid local real property taxes of $4,000 and state income taxes of $5,000 in 2018. Amy’s state and local tax deduction was not limited by IRC section 164(b)(6) because it was below $10,000. Including other allowable itemized deductions, Amy claimed a total of $14,000 in itemized deductions on her 2018 federal income tax return. In 2019, Amy received a $1,500 state income tax refund due to her overpayment of state income taxes in 2018. Had she paid only the proper amount of state income tax in 2018, her state and local tax deduction would have been reduced from $9,000 to $7,500. As a result, Amy’s itemized deductions would have been reduced from $14,000 to $12,500, a difference of $1,500. Amy received a tax benefit from the overpayment of $1,500 in state income tax in 2018. Thus, Amy is required to include the entire $1,500 state income tax refund in her gross income for 2019.

Example #2
Brenda paid local real property taxes of $5,000 and state income taxes of $7,000 in 2018. IRC section 164(b)(6) limited her state and local tax deduction on her 2018 federal income tax return to $10,000. Brenda could not deduct $2,000 of the $12,000 state and local taxes paid. Including other allowable itemized deductions, Brenda claimed a total of $15,000 in itemized deductions on her 2018 federal income tax return. In 2019, Brenda received a $750 state income tax refund due to her overpayment of state income taxes in 2018. Had she paid only the proper amount of state income tax in 2018, her state and local tax deduction would have remained the same ($10,000) and Brenda’s itemized deductions would have remained the same ($15,000). Brenda received no tax benefit from the overpayment of $750 in state income tax in 2018. Thus, she is not required to include the $750 state income tax refund in gross income for 2019.

Example #3
Cameron paid local real property taxes of $5,000 and state income taxes of $6,000 in 2018. IRC section 164(b)(6) limited Cameron’s state and local tax deduction on her 2018 federal income tax return to $10,000. As a result, Cameron could not deduct $1,000 of the $11,000 state and local taxes paid. Including other allowable itemized deductions, Cameron claimed a total of $15,000 in itemized deductions on her 2018 federal income tax return. In 2019, Cameron received a $1,500 state income tax refund due to overpayment of state income taxes in 2018. Had she paid only the proper amount of state income tax in 2018, Cameron’s state and local tax deduction would have been reduced from $10,000 to $9,500. As a result, Cameron’s itemized deductions would have been reduced from $15,000 to $14,500, a difference of $500. Cameron received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, she is required to include $500 of the state income tax refund in gross income for 2019.
Deb paid local real property taxes of $4,250 and state income taxes of $6,000 in 2018. IRC section 164(b)(6) limited Deb’s state and local tax deduction on her 2018 federal income tax return to $10,000. Thus, Deb could not deduct $250 of the $10,250 state and local taxes paid. Including other allowable itemized deductions, Deb claimed a total of $12,500 in itemized deductions on her 2018 federal income tax return. In 2019, she received a $1,000 state income tax refund due to the overpayment of state income taxes in 2018. Had Deb paid only the proper amount of state income tax in 2018, her state and local tax deduction would have been reduced from $10,000 to $9,250. As a result, Deb’s itemized deductions would have been reduced from $12,500 to $11,750, which is less than the standard deduction of $12,000 for 2018. The difference between Deb’s claimed itemized deductions ($12,500) and the standard deduction she could have taken ($12,000) is $500. Deb received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, Deb is required to include $500 of her state income tax refund in gross income for 2019.

**Summary.** If a taxpayer received a tax benefit from deducting state or local taxes in a prior year and the taxpayer recovers all or a portion of those taxes in the current year, the taxpayer must include in gross income the lesser of:

1) The difference between the taxpayer’s total itemized deductions taken in the prior year and the amount of itemized deductions the taxpayer would have taken in the prior year had the taxpayer paid the proper amount of state and local tax, or

2) The difference between the taxpayer’s itemized deductions taken in the prior year and the standard deduction amount for that prior year, if the taxpayer was not precluded from taking the standard deduction in that prior year.