

Taxability of State and Local Tax Refunds Next Year

IRS has released Revenue Ruling 2019-11 which addresses the taxability of a state or local tax refund received. The Tax Cuts and Jobs Act of 2017 created a \$10,000 limitation for the state and local tax (SALT) deduction on Schedule A. Ever since this limitation was created, we have been asking; "How is the taxable portion of a refund of state or local taxes, especially income taxes, going to be calculated when we file the taxpayer's 2019 and later years' returns?"

Now IRS has finally addressed this question by providing us with Revenue Ruling 2019-11 which basically says we should look at the tax benefit the taxpayer received by claiming the deduction. Briefly this 6-page document says, 'go back and recalculate the "proper" deduction (the real tax the government kept) and see if your SALT deduction changes.' However, just as in prior years, if the standard deduction would kick in when using the new SALT amounts, then the taxable amount of the refund is further reduced. The 6-page document give four examples which we are copying here:

Situation 1: Taxpayer A paid local real property taxes of \$4,000 and state income taxes of \$5,000 in 2018. A's state and local tax deduction was not limited by section 164(b)(6) because it was below \$10,000. Including other allowable itemized deductions, A claimed a total of \$14,000 in itemized deductions on A's 2018 federal income tax return. In 2019, A received a \$1,500 state income tax refund due to A's overpayment of state income taxes in 2018.

RESULT – STATE INCOME TAX REFUND FULLY INCLUDIBLE. Had A paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from \$9,000 to \$7,500 and as a result, A's itemized deductions would have been reduced from \$14,000 to \$12,500, a difference of \$1,500. A received a tax benefit from the overpayment of \$1,500 in state income tax in 2018. Thus, A is required to include the entire \$1,500 state income tax refund in A's gross income in 2019.

Situation 2: Taxpayer B paid local real property taxes of \$5,000 and state income taxes of \$7,000 in 2018. Section 164(b)(6) limited B's state and local tax deduction on B's 2018 federal income tax return to \$10,000, so B could not deduct \$2,000 of the \$12,000 state and local taxes paid. Including other allowable itemized deductions, B claimed a total of \$15,000 in itemized deductions on B's 2018 federal income tax return. In 2019, B received a \$750 state income tax refund due to B's overpayment of state income taxes in 2018.

RESULT – STATE INCOME TAX REFUND NOT INCLUDIBLE. Had B paid only the proper amount of state income tax in 2018, B's state and local tax deduction would have remained the same (\$10,000) and B's itemized deductions would have remained the same (\$15,000). B received no tax benefit from the

overpayment of \$750 in state income tax in 2018. Thus, B is not required to include the \$750 state income tax refund in B's gross income in 2019.

Situation 3: Taxpayer C paid local real property taxes of \$5,000 and state income taxes of \$6,000 in 2018. Section 164(b)(6) limited C's state and local tax deduction on C's 2018 federal income tax return to \$10,000, so C could not deduct \$1,000 of the \$11,000 state and local taxes paid. Including other allowable itemized deductions, C claimed a total of \$15,000 in itemized deductions on C's 2018 federal income tax return. In 2019, C received a \$1,500 state income tax refund due to C's overpayment of state income taxes in 2018.

RESULT – STATE INCOME TAX REFUND PARTIALLY INCLUDIBLE. Had C paid only the proper amount of state income tax in 2018, C's state and local tax deduction would have been reduced from \$10,000 to \$9,500 and as a result, C's itemized deductions would have been reduced from \$15,000 to \$14,500, a difference of \$500. C received a tax benefit from \$500 of the overpayment of state income tax in 2018. Thus, C is required to include \$500 of C's state income tax refund in C's gross income in 2019.

Situation 4: Taxpayer D paid local real property taxes of \$4,250 and state income taxes of \$6,000 in 2018. Section 164(b)(6) limited D's state and local tax deduction on D's 2018 federal income tax return to \$10,000, so D could not deduct \$250 of the \$10,250 state and local taxes paid. Including other allowable itemized deductions, D claimed a total of \$12,500 in itemized deductions on D's 2018 federal income tax return. In 2019, D received a \$1,000 state income tax refund due to D's overpayment of state income taxes in 2018.

RESULT – STANDARD DEDUCTION COULD HAVE BEEN USED. Had D paid only the proper amount of state income tax in 2018, D's state and local tax deduction would have been reduced from \$10,000 to \$9,250, and, as a result, D's itemized deductions would have been reduced from \$12,500 to \$11,750, which is less than the standard deduction of \$12,000 that D would have taken in 2018. The difference between D's claimed itemized deductions (\$12,500) and the standard deduction D could have taken (\$12,000) is \$500. D received a tax benefit from \$500 of the overpayment of state income tax in 2018. Thus, D is required to include \$500 of D's state income tax refund in D's gross income in 2019.

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