

Section 111.—Recovery of Tax Benefit Items

26 CFR 1.111-1: Recovery of certain items previously deducted or credited.
(Also: § 164; 1.164-1.)

Rev. Rul. 2019-11

ISSUE

If a taxpayer received a tax benefit from deducting state and local taxes under section 164 of the Internal Revenue Code in a prior taxable year, and the taxpayer recovers all or a portion of those taxes in the current taxable year, what portion of the recovery must the taxpayer include in gross income?

FACTS

In Situations 1 through 4 below, the taxpayers are unmarried individuals whose filing status is “single” and who itemized deductions on their federal income tax returns for 2018 in lieu of using their standard deduction of \$12,000. The taxpayers did not pay or accrue the taxes in carrying on a trade or business or an activity described in section 212. For 2018, the taxpayers were not subject to alternative minimum tax under section 55 and were not entitled to any credit against income tax. The taxpayers use the cash receipts and disbursements method of accounting.

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.

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.

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.

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.

LAW AND ANALYSIS

Section 164 generally provides an itemized deduction for certain taxes paid or accrued during the taxable year. Section 164(a) provides a deduction for (1) state and local, and foreign, real property taxes; (2) state and local personal property taxes; (3) state and local, and foreign, income, war profits and excess profits taxes; and (4) the generation-skipping transfer tax imposed on income distributions. Section 164(a) also provides a deduction for state and local, and foreign, taxes not previously described that were paid or accrued within the taxable year in carrying on any trade or business or an activity described in section 212 (relating to expenses for production of income). Section 164(b)(5) allows a taxpayer to elect to deduct state and local general sales taxes in lieu of state and local income taxes.

Section 164(b)(6), as added by section 11042 of the "Tax Cuts and Jobs Act" (the "Act"), Pub. L. 115-97, limits an individual's deduction for the aggregate amount of state and local taxes paid during the calendar year to \$10,000 (\$5,000 in the case of a married individual filing a separate return). The dollar limitations apply to taxable years beginning after December 31, 2017, and before January 1, 2026, but they do not apply to foreign taxes described in section 164(a)(3) or to any taxes described in section 164(a)(1) and (2) that are paid or accrued in carrying on a trade or business or an activity described in section 212.

Section 111(a) excludes from gross income amounts attributable to the recovery during the taxable year of any amount deducted in any prior year to the extent the amount did not reduce the amount of tax imposed by Chapter 1 of the Code. Section 111 partially codifies the tax benefit rule, which generally requires a taxpayer to include in gross income recovered amounts that the taxpayer deducted in a prior taxable year to the extent those amounts reduced the taxpayer's tax liability in the prior year. See Rev. Rul. 93-75, 1993-2 C.B. 63.

If the taxpayers in Situations 1 through 4 had paid only the proper amount of state and local tax in the prior taxable year, their itemized deductions may have been lower or they may have opted for the standard deduction. Thus, the taxpayer in each situation must determine the amount of itemized deductions that the taxpayer would have deducted in the prior year had the taxpayer paid only the proper amount of tax. The taxpayer must then compare this amount to the total itemized deductions actually taken on the return, or the standard deduction that could have been taken on the return, and include the difference as income on the current year return if the taxpayer received a tax benefit in the prior taxable year from that itemized deduction.

Situation 1: State income tax refund fully includable. In 2019, A received a \$1,500 refund of state income taxes paid in 2018. 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: State income tax refund not includable. In 2019, B received a \$750 refund of state income taxes paid in 2018. 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: State income tax refund partially includable. In 2019, C received a \$1,500 refund of state income taxes paid in 2018. 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: Standard deduction. In 2019, D received a \$1,000 refund of state income taxes paid in 2018. 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.

HOLDING

If a taxpayer received a tax benefit from deducting state or local taxes in a prior taxable year and the taxpayer recovers all or a portion of those taxes in the current taxable 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 the prior year, if the taxpayer was not precluded from taking the standard deduction in the prior year. This holding applies to the recovery of any state or local tax, including state or local income tax and state or local real or personal property tax.

DRAFTING INFORMATION

The principal author of this revenue ruling is Amy S. Wei of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Amy S. Wei at (202) 317-7011 (not a toll-free call).