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## New IRS Guidance on State and Local Tax Refunds

The Tax Cuts and Jobs Act of 2017 included a \$10,000 (\$5,000 if married filing separately) cap on the amount of state and local taxes that can be claimed as an itemized deduction on Schedule A of Form 1040. If you itemize deductions that include a deduction for state and local taxes and then subsequently receive a state or local tax refund, you may have to include part or all of the refund as income in the year you receive it. There were some questions about how the new \$10,000 cap would affect the amount of any such refund that would be included in income.



### IRS guidance

In general, if you receive a federal tax benefit from deducting state or local taxes in a prior taxable year and then subsequently recover (receive a refund for) some or all of the state or local taxes you had deducted, you have to do a two-part calculation. The first part of the calculation is to go back and determine what your total itemized deduction amount in the prior year would have been if you had paid the correct amount of state and local taxes and subtract that from the amount you originally claimed. The second part of the calculation is the difference between your itemized deductions taken in the prior year and the standard deduction amount (including adjustments for being blind or age 65 or older) for the prior year, provided that you could have claimed the standard deduction that year. The amount of the state or local refund that needs to be included in your income is the smaller of these two amounts.

For the 2019 IRS Form 1040 tax return, it is likely that the instructions for the line "Taxable refunds, credits, or offsets of state and local income taxes" will contain a simple worksheet for implementing this general rule. It will probably also include numerous exceptions that will require the use of a more complicated worksheet in IRS Publication 525. Exceptions might include (among others): you owed alternative minimum tax in 2018; you couldn't use the full amount of credits you were entitled to in 2018; you could be claimed as a dependent by someone else in 2018; or you received a refund on a jointly filed state or local income tax return, but you aren't filing a 2019 joint tax return with the same person.

### Example

Assume no exceptions to the general rule apply. You paid local real property taxes of \$5,000 and state income taxes of \$6,000 in 2018. Your state and local tax deduction was limited to \$10,000, so you could not deduct \$1,000 of the \$11,000 state and local taxes paid. Including other allowable itemized deductions, you claimed a total of \$15,000 in itemized deductions on the 2018 federal income tax return. In 2019, you received a \$1,500 state income tax refund due to overpayment of state income taxes in 2018.

If you had paid only the proper amount of state income tax in 2018, the state and local tax deduction would have been reduced from \$10,000 to \$9,500 and, as a result, itemized deductions would have been reduced from \$15,000 to \$14,500, a difference of \$500 (the first calculation).

You filed as a single taxpayer and were entitled to a standard deduction of \$12,000 in 2018. The \$15,000 of itemized deductions taken in the previous year exceeded the standard deduction by \$3,000 (the second calculation).

The smaller of the two calculation amounts is \$500. Therefore, you received a \$500 tax benefit due to overpayment of state income tax in 2018. Thus, you are required to include \$500 of the state income tax refund in gross income for 2019.

*If you received a federal tax benefit from deducting state and local taxes as an itemized deduction in a prior taxable year and you recover all or a portion of those taxes in the current taxable year, you may need to include a portion of the recovery in gross income.*



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