

IRS Rules California Middle Class Tax Refunds Are Not Taxable

By Robert W. Wood

Are refunds of state taxes taxed by the IRS? It turns out to be a surprisingly complex topic. And it was made even more complex over the past year by the patchwork of states—including California—that decided to offer some extra pandemic relief in the form of refunds or rebates of state taxes. Of course, getting a check in the mail is always nice, whatever the circumstances. But any check is a little less attractive if you find out that you have to take it into income and disclose it to the IRS on your tax return.

As taxpayers and tax return preparers started turning to 2022 tax preparation this time of year, those rebate checks became controversial. And it wasn't just California. A total of 21 states offered some kind of rebate or refund. That meant that taxpayers and their tax preparers were all trying to figure out which way the IRS would jump on this issue. Even the IRS was advising people not to file their taxes just yet, so the agency had time to evaluate the situation and to issue some guidance.

The IRS has now done that, announcing that special payments made by 21 states in 2022 are not taxable and don't need to be reported on your 2022 taxes. It means that people in the following states do not need to report these state payments on their 2022 tax return: California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maine, New Jersey, New Mexico, New York, Oregon, Pennsylvania and Rhode Island. Alaska is in this group as well, though it is a more nuanced question there. Finally, many people in Georgia, Massachusetts, South Carolina and Virginia also will not include state payments in income for federal tax purposes if they meet certain requirements.

How does this "don't worry about it" relief from the IRS stack up against the usual IRS rules for tax refunds? The usual rules are surprisingly fact specific. Suppose that you receive an IRS Form 1099-G reporting the state tax refund that you received during 2022. Do you have to include that payment as income on your federal tax return? It depends. Whether your state income tax refund is taxable on your federal income tax return depends on whether you took an itemized deduction for the tax that was later refunded.

If you did not itemize (say you just claimed the standard deduction), you don't need to report any part of the state tax refund on your federal return. But what if you itemized and claimed a deduction for state taxes (some of which you got back)? If you took an itemized deduction for taxes paid that were later refunded, you may have to include all or part of the refund as income on your tax return. The IRS has a complex worksheet you can use to determine how much if any of that deduction you essentially have to recapture.

In the recent guidance the IRS issued about the state rebates, the IRS included a helpful review of these general rules. In general, when you receive a refund of state taxes paid, if you claimed the standard deduction or if you itemized deductions but did not receive a tax benefit (for example,

because the \$10,000 tax deduction limit applied) the payment is not included in income for federal tax purposes. The IRS said it would apply this usual rule to the 2022 pandemic tax rebates made by the states of Georgia, Massachusetts, South Carolina and Virginia.

How about California (and other states)? Taxpayers in California and numerous other states got a better deal, courtesy of two little known tax rules that the IRS have been applying more and more in recent years. The first is the general welfare doctrine, also known as the general welfare exclusion from income. The other are the rules for qualified disaster relief payments. If a payment is made for the promotion of the general welfare or as a qualified disaster relief payment, say related to the pandemic, it may be excludable from income for federal tax purposes.

Determining whether payments qualify for these exceptions to the usual "everything is income" rule can be complex and fact intensive, and the result can depend on a number of considerations. But in a few words, the general welfare exception requires that payments be made under legislatively provided social benefit programs for the promotion of the general welfare. In determining its applicability, the IRS requires the payments to be:

1. made from a governmental general welfare fund;
2. for the promotion of the general welfare (that is, on the basis of need rather than to all residents); and
3. not made as payment regarding services.

It is easy to go down the rabbit whole with each of these three big requirements. In general, though, the general welfare exception has generally been limited to individuals who receive governmental payments to help them with their individual needs (for example, housing, education, and basic sustenance expenses). Grant payments that compensate for lost profits or business income (whether to individuals or to businesses) do not qualify. The IRS has used the general welfare exception extensively with payment to native Americans and in a few other contexts.

A "qualified disaster relief payment" is defined by section 139(b) of the tax code to include any amount paid to or for the benefit of an individual to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster. Qualified disaster relief payments do not include income replacements such as sick leave or other paid time off paid by an employer.

In the recent guidance, the IRS includes the California refunds in the list of states that it evaluated under the general welfare exception and qualified disaster relief authorities.

The IRS said that given the complicated fact-specific nature of evaluating these payments for federal tax purposes, it was ruling that these 2022 refunds/rebates do not have to be reported as income. Among other justifications for this result, the IRS said this was only a 2022 issue, since the pandemic emergency declaration is ending in May, 2023.

Curiously, the IRS phrased it not so much as a determination that these payments were not taxable. Rather, the IRS said that if you do not include the amount in your 2022 income for federal income tax purposes, the IRS will not challenge you. However, the IRS also reminded people that outside of this unusual relief, most payments made by states are generally includable in income for federal income tax purposes. Still, the announcement came as a big relief to lots of California taxpayers.

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