

ARE NEBRASKA PTET REFUNDS FEDERALLY TAXABLE? TAX BENEFIT RULE

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Whether a state tax refund is includable as taxable income on a federal return depends on the application of the tax benefit rule. The rule says, if a refund can be linked to a prior deduction which the taxpayer benefitted from, the refund is taxable to the extent of that benefit. So, the question to answer is this: If a taxpayer received a tax benefit 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 recovered amount must the taxpayer include in federal gross income?

For background, in November 2020 the IRS released Notice 2020-75, which provided that proposed regulations would be forthcoming, while also clarifying that state and local taxes imposed on and paid by a partnership or S corporation, referred to as specified income tax payments (SITPs), would be allowed as a deduction by the pass-through entity in computing its non-separately stated federal taxable income or loss for the tax year of payment. To note, refunds of federal income taxes are not included in income because payments of federal income taxes are not deductible.

One significant question that remains unanswered by the notice is whether refundable PTET credits are includable in income under the Code Section 111. The term “tax benefit rule” encompasses two concepts, an inclusionary part and an exclusionary part. The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year’s income when a fundamentally inconsistent event has occurred. The exclusionary part is currently codified in Code Section 111 and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

Guidance and Authority

Several authorities provide insights into the tax treatment of recovered state taxes:

- Revenue Ruling 70-86.
A refund by the state of taxes previously paid is a recovery of those taxes and is generally not includable in federal gross income to the extent that the underlying payment of those taxes was not deducted on a prior year federal income tax return.
- Revenue Ruling 2019-11.
This revenue ruling provides guidance for the application of the tax benefit rule as applied to the \$10,000 SALT cap. In general, if a taxpayer received a tax benefit from deducting state or local taxes in a prior tax year and the taxpayer recovers all or a portion of those taxes in the current tax 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.
- IRS Notice 2023-56
This notice offers guidance on the taxable nature of state tax refunds, with an emphasis on the definition of a “state tax refund.” The notice highlights that a refundable credit constitutes a state tax

refund to the extent that it reflects taxes previously paid by the taxpayer. However, it distinguishes that credits utilized to offset or diminish a taxpayer's tax liability are generally not subject to taxation. This nuanced clarification is essential for discerning whether a refund qualifies as a "state tax refund" under the defined criteria.

- Roydell Campbell v. Commissioner, T.C. Memo 2001-118.

If state income tax was deducted on a federal income tax return for a prior taxable year and if such deduction resulted in a tax benefit to the taxpayer, such as a reduction of federal income tax for the prior taxable year, a subsequent recovery by the taxpayer of the state income tax must be included in the taxpayer's gross income for federal income tax purposes in the year in which the recovery is received.

- Maines v. Commissioner, 144 T.C. 123 (2015).

The Maineses owned two pass-through business entities that qualified for three different types of refundable state economic development credits.

The first type of credit in this case was a refundable state economic development credit based upon property taxes which implicated the tax benefit rule. The amount of credit that was not used to offset state-tax liability was deemed a refund of property taxes. The refund amount was includible in federal gross income only to the extent that a tax benefit had previously been received for payment of the property taxes. In this case, the tax benefit came from a deduction at the pass-through entity for the payment of property tax. The tax benefit rule was not limited to cases where the same person receives both the deduction in the earlier year and the recovery in the later year. *See also* Elbaz v. Commissioner, T.C. Memo. 2015-49; Ginsburg v. United States, 922 F.3d 1320 (Fed. Cir. 2019) (portion of refundable brownfield development state tax credit in excess of taxpayer's state tax liability (i.e., amount of state tax refund generated by state tax credit) must be included in taxpayer's federal gross income).

The other two credits were attributable to investments and wages paid by the pass-through entities. While the state defined these credits as overpayments of state tax, the label used by the state was not controlling for federal tax purposes. The Tax Court held that these refundable credits were not limited to prior state tax payments and, accordingly, did not constitute a refund of past state tax overpayments. The tax benefit rule did not apply since these refunds did not represent state tax refunds. Instead, the refunds attributable to these credits were deemed to represent direct subsidies and as such accessions to wealth were includible in taxable income under Code Section 61.

Conclusion

As of now, there is no issued authority or guidance indicating that the IRS has taken a position about the taxability of refunds attributable to Nebraska PTET credits, or any other state PTET credits. Accountants should be aware that a refund generated by PTET credits may potentially result in taxable income under the tax benefit rule or as an accession to wealth. In the absence of explicit IRS guidance, informing clients about associated risks becomes crucial for making informed decisions.

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