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Tax Benefit Rule – Recovery of Previous Deduction Could Be Non-taxable

Most people are familiar with Benjamin Franklin's famous phrase "nothing is certain except death and taxes". We are paying all sort of taxes on a daily basis such as sales tax, income tax, property tax, etc. Even after we die, there may be death taxes to be paid. Can anything escape from being taxed?

In general, all income is subject to income tax except specifically excluded under Internal Revenue Code. This includes recovery during the current taxable year of any amount deducted in any prior taxable year. However, if the amount recovered did not reduce tax in earlier year when the deduction was claimed, such recovered amount is excluded from taxable income in the year of recovery. If the prior year's deduction produced a partial tax benefit, then only the portion to the extent tax benefit was provided is includable in income in the year of recovery.

Example 1:
In 2015 tax return, Terry, a single individual taxpayer at age of 50, claimed itemized deduction of $45,000 including state income tax deduction for withholding from his paychecks of $7,000. His adjusted gross income was $100,000 and he was able to utilize the entire itemized deduction. In 2016, he received state income tax refund of $1,500. The entire refund of $1,500 is taxable income for tax year 2016.

Example 2:
Assuming the same facts as Example 1 except Terry was subject to Alternative Minimum Tax (AMT) in 2015. As a result, the state income tax deduction of $7,000 provided no tax benefit in 2015. When refund of $1,500 was received in 2016, such refund excluded from gross income.

Example 3:
Assume the same facts as Example 1. Further, Terry's itemized deductions included medical expense deduction of $1,000 which represented total medical expenses of $11,000 less 10% AGI limitation of $10,000. In 2016, Terry received $4,000 insurance reimbursement for his 2015 medical expenses. According to the tax benefit rule, only $1,000 out of the $4,000 refund is taxable in 2016.

Commonly seen recoveries that can be excluded from income are recoveries of deductions related to itemized deductions such as state income tax and property tax refund. However, tax benefit rule also applies to non-itemized deductions and tax credit. If a taxpayer received a recovery for an item for which he claimed a tax credit in earlier year, he must increase his tax by the amount of the recovery up to the amount by which the credit reduced his tax in earlier year in the year of recovery. This rule does not apply to investment tax credit or the foreign tax credit since those provisions already contain their own credit recovery rules.

Example 4:
Suzy incurred qualified education expenses of $10,000 in 2015. She claimed lifetime learning credit of $2,000 which reduced her income tax liability from $5,275 to $3,275 on her 2015 return. In 2016, she received a refund of $4,000. As such, lifetime learning credit for 2015 is recomputed to be $1,200 (20% of education expenses of $10,000 less refund of $4,000). Therefore, she must increase her 2016 tax by $800 (original credit claimed of $2,000 less recomputed credit of $1,200).

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