Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201423020**
Release Date: 6/6/2014

CC:ITA:B04:CMGlendening
POSTF-150853-13

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 61.00-00, 111.01-00, 111.06-00

date: March 12, 2014

to: Mark A. Ericson
Attorney (Long Island)
(Tax Exempt & Government Entities)

from: Donna Welsh
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

---

subject: Treatment of the Massachusetts Senior Circuit Breaker Credit for federal income tax purposes.

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

What is the proper federal income tax treatment of the Massachusetts Senior Circuit Breaker Credit (the Credit)?

CONCLUSIONS

The amount of the Credit that reduces a potential state income tax liability as part of computing how much state tax is due is not includable in federal gross income and is not deductible for federal tax purposes. The proper federal income tax treatment of the amount of the Credit not used in a taxable year to reduce an income tax liability (that is, the refundable portion of the Credit) depends on the tax situation of the taxpayer. First, a taxpayer who rents a residence and receives the refundable portion of the Credit is not required to include that amount in gross income under the general welfare

exclusion. Next, a taxpayer who owns a home and pays real estate taxes to a local government, and who does not itemize its deductions for federal income tax purposes, does not include the refundable portion of the Credit in gross income. In this situation, the refundable portion is treated as a return of capital with no tax consequences. Lastly, a taxpayer who owns a home and pays real estate taxes to a local government, and who itemizes its deductions for federal income tax purposes in a prior year, must include the refundable portion of the Credit in income except to the extent that the deduction did not reduce the tax imposed.

FACTS

The state of Massachusetts (State) provides a refundable credit against state income taxes to certain eligible low-income State residents who paid real estate taxes or rent during the taxable year. ALM GL ch. 62, § 6(k). The Credit offsets State income tax liability, and the excess, if any, is refunded to the taxpayer. ALM GL ch. 62, § 6(k)(7). State enacted the Credit to help low income senior citizens defray the cost of housing. Although the Credit is based on property taxes imposed by, and paid to, local governments, the State government is the entity that pays the Credit. The Credit is allowable for senior homeowners and renters who meet certain income limits and other eligibility requirements.

To be eligible for the Credit, an individual must: (1) be an owner or tenant of residential property located in State; (2) be aged 65 or older; (3) not be a dependent of another taxpayer; and (4) occupy the property as his principal residence. ALM GL ch. 62, § 6(k)(2).

The Credit is allowable only to taxpayers whose State total income does not exceed $40,000 (as adjusted for inflation) for a single individual, $50,000 (as adjusted for inflation) for a head of household individual, and $60,000 (as adjusted for inflation) for married individuals filing a joint return. Additionally, the assessed value of the taxpayer's residence cannot exceed $600,000 (as adjusted for inflation). ALM GL ch. 62, § 6(k)(3), (4).

For purposes of the Credit, a taxpayer's State "total income" is the sum of the taxpayer's State adjusted gross income, increased by the following to the extent excluded or subtracted from adjusted gross income: income and receipts from social security, retirement, pension, annuities, cash (but not in-kind) public assistance, and tax-exempt interest and dividends. ALM GL ch. 62, § 6(k)(1).

The amount of the Credit depends on whether the taxpayer generally is a homeowner or renter. For homeowners, the amount of the Credit is equal to the amount by which the real estate taxes paid during the taxable year, including water and sewer charges as applicable, exceeds 10 percent of the taxpayer's total income. For renters, the amount of the Credit is equal to the amount by which the "rent constituting real estate tax payment" exceeds 10 percent of the taxpayer's total income. "Rent constituting real

estate tax payment" equals 25 percent of the rent that the taxpayer pays during the taxable year, under a good faith rental agreement, for the right of occupancy of the residence. For both homeowners and renters, the amount of the Credit cannot exceed the lesser of $750 (as adjusted for inflation) or the amount of real estate taxes paid (or the "rent constituting real estate tax payment"). ALM GL ch. 62, § 6(k)(1), (2).

State real property taxes are assessed by, and paid to, local government entities. The State grants local governments the authority to assess and collect taxes. ALM GL ch. 59, §§ 2, 11. Thus, although local governments impose the real estate tax, and State makes the Credit payment, State has a degree of control over the local governments such that the local governments are an integral part of State. Therefore, State is not an unrelated third party reimbursing taxpayers for real estate taxes paid because the State is indistinguishable from the local governments.

LAW

Section 61(a) of the Internal Revenue Code (Code) provides that, except as otherwise provided in subtitle A, gross income means all income from whatever source derived. *See also* § 1.61-1(a) of the Income Tax Regulations. Gross income is an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 1955-1 C.B. 207.

Although many state tax credits are only used to reduce a state tax liability, some may also be refundable, such as the Credit. The amount of a state tax credit that reduces a potential tax liability as part of computing how much tax is due to the state does not represent an accession to wealth. Therefore, this amount is not includable in gross income; instead, it will generally be reflected in a reduced federal deduction for state tax under § 164 of the Code. *Tempel v. Commissioner*, 136 T.C. 341 (2011), *aff'd sub nom. Esgar Corp. v. Commissioner*, 2014 U.S. App. LEXIS 4261 (10th Cir. 2014). Generally, a refundable state tax credit is treated for federal income tax purposes as a reduction in the recipient's state tax liability, and any excess over the state tax liability is treated as a payment from the state and is includible in gross income under § 61 unless an exclusion applies.

Governmental grants are includible in gross income under § 61 of the Code unless excluded from gross income by law. *See* Rev. Rul. 85-39, 1985-1 C.B. 21 (dividend payments Alaska makes to all adult residents to encourage them to remain in the state and thereby reduce social, economic and political instability are gross income under § 61).

The Internal Revenue Service (Service), however, has held that payments under legislatively provided social benefit programs for the promotion of the general welfare are not includible in an individual's gross income (the general welfare exclusion). In determining whether the general welfare exclusion applies to payments, the Service generally requires that the payments: (1) be made from a governmental fund; (2) be for

the promotion of the general welfare (*i.e.,* on the basis of need rather than to all residents regardless of financial status, health, educational background, or employment status); and (3) not be made for services that the recipient provides. *See* Rev. Rul. 98-19, 1998-1 C.B. 840; Rev. Rul. 74-205, 1974-1 C.B. 20.

Section 164 of the Code provides, in part, a deduction for the state and local income and real property taxes paid or accrued during a taxable year.

Under the tax benefit rule, the recovery of taxes deducted in an earlier taxable year is includible in gross income except to the extent that the deduction did not reduce tax imposed. The tax benefit rule includes two components, an inclusionary part and an exclusionary part. Generally, the inclusionary part of the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 383 (1983). The exclusionary part of the tax benefit rule is codified in § 111(a) of the Code and allows a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

A taxpayer who receives a rebate of state taxes that the taxpayer did not previously deduct on a prior year's federal income tax return is not required to include the rebate in gross income because it is a return of a capital with no tax consequences. *See* Rev. Rul. 93-75, 1993-2 C.B. 63.

ANALYSIS

The following examples illustrate the proper federal income tax treatment of the Credit for taxpayers with different tax situations. In each example, the taxpayer meets the age requirements for the Credit and does not have any state estimated tax payments or withholding.

<u>Example 1</u>: A is an individual who receives $40,000 in State total income for Year 1. A rents an apartment for Year 1 and pays $20,000 in rent during Year 1. A does not pay any real estate taxes during Year 1. However, 25 percent of the rent is "rent constituting real estate taxes paid" for purposes of the Credit. Thus, the amount of A's rent constituting real estate taxes paid is $5,000 (.25 x 20,000) for Year 1. A's maximum allowable Credit amount is $1,000 (5,000 – 4,000 (.10 x $40,000 State total income) for Year 1; however, A's allowable credit is limited to $750. A's State income tax liability before the Credit is $500 for Year 1. Therefore, after the Credit A's State income tax liability is reduced to zero for Year 1. In Year 2, A receives the $250 refundable portion of the Credit.

In this case, for Year 2, for federal tax purposes the $500 portion of the Credit that reduced A's state income tax liability to zero is a reduction in a potential tax liability, not an item of income. If A itemized her deductions, her deduction for state income tax

under § 164 would be zero. The $250 refundable portion of the Credit that A receives in Year 2 is not a rebate of rent paid by the lessor and is an item of income; however, it is excluded from A's gross income under the general welfare exclusion because the Credit is made from a governmental fund to individuals based on financial need and is not a payment for services.

Example 2: B is a single individual who receives $30,000 in State total income for Year 1. B owns and uses a home as his principal residence. The assessed value of B's principal residence is $350,000, and B pays $4,000 in local real estate taxes in Year 1. Thus, B's maximum allowable Credit amount is $1,000 ($4,000- $3,000 (.10 x $30,000 State total income) for Year 1; however, B's allowable Credit is limited to $750. B's State income tax liability before the Credit is $500 for Year 1. Therefore, after the Credit, B's state income tax liability is reduced to zero for Year 1. In Year 2, B receives the $250 refundable portion of the Credit. B did not deduct local real estate taxes on his federal income tax return for Year 1.

In this case, for Year 2, for federal tax purposes the $500 portion of the Credit that reduced B's state income tax liability to zero is a reduction in a potential tax liability, not an item of income. If B itemized his deductions, his deduction for state income tax under § 164 would be zero. The $250 refundable portion of the Credit that B receives in Year 2 is a recovery of the real estate taxes that B paid in Year 1, because the formula to calculate the Credit is based on real estate taxes paid and is paid by the State, which is indistinguishable from the local governments. However, because B did not previously deduct the real estate taxes, the $250 refundable portion is not an item of gross income and has no federal tax consequences.

Example 3: The facts are the same as Example 2, except that, for federal income tax purposes, C itemizes his deductions and deducts the $4,000 real estate taxes paid in Year 1 under § 164 of the Code on his Year 1 federal income tax return. The full $4,000 deduction reduced C's federal income tax in Year 1.

In this case, for Year 2, for federal tax purposes the $500 portion of the Credit that reduced C's state income tax liability to zero is a reduction in a potential tax liability, not an item of income, and is not includible in federal gross income under the tax benefit rule. However, C's deduction for state income tax under § 164 is zero. The $250 refundable portion of the Credit is treated as a recovery of the real estate taxes that C paid in Year 1, which is fundamentally inconsistent with his prior deduction. The inclusionary part of the tax benefit rule applies to the $250 refundable portion, and the general welfare exclusion does not apply to income includible under the tax benefit rule.

Because C's Year 1 deduction for local real estate tax reduced C's federal tax for Year 1, the $250 that C receives in Year 2 is includable in federal gross income in Year 2 and is reportable on line 21 of Form 1040.

Please call Christina Glendening at (202) 317-4718 if you have any further questions.

____
Donna Welsh
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)