

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200504027**

Release Date: 1/28/2005

CC:ITA:B04:
POSTF-149540-04

UILC: 61.13-07, 111.06-00, 164.01-00

date: December 21, 2004

to: Area Counsel
(Small Business/Self- Employed: Area 1)

from: Robert M. Brown
Associate Chief Counsel
(Income Tax & Accounting)

subject:

New York City Real Property Tax Rebate

This Chief Counsel Advice responds to your request for assistance dated October 15, 2004. Specifically, you have asked our office to review your memorandum and determine the proper federal income tax treatment of a New York City real property tax rebate under §§ 61, 111, and 164 of the Internal Revenue Code. This advice may not be used or cited as precedent.

ISSUE

What is the proper federal income tax treatment of the New York City real property tax rebate?

CONCLUSION

A taxpayer who receives a rebate of New York City real property tax previously deducted on a prior year's federal income tax return must include the rebate in gross income in the year received to the extent of any federal income tax benefit. A taxpayer who receives a rebate of New York City real property tax not previously deducted on a prior year's federal income tax return is not required to include the rebate in gross income in the year received. However, in either situation a taxpayer must include the rebate of the tax in gross income to the extent that it exceeds the real property tax paid by the taxpayer. Illustrative situations are set forth below.

FACTS

On July 29, 2004, New York City amended Title 11 of its Administrative Code by adding § 11-239, which provides for a rebate of real property taxes on certain residential property. For fiscal years beginning on July 1, 2003, and ending on June 30, 2006, qualified homeowners will receive a real property tax rebate for each fiscal year. This rebate is contingent upon the City Council's decision not to increase real property taxes for the next fiscal year. If real property taxes are increased, then the rebate is rolled back. The amount of the rebate is \$400, or the property's annual tax liability, whichever is less.

Under § 11-239, a qualified homeowner is defined as an owner of property that is a one, two, or three family residence or a residential cooperative or condominium. The property must be a primary residence of one or more of the owners. Further, the owner must not be in arrears on property taxes in an amount over \$25. For cooperative buildings, total arrears on the building may not exceed, in the aggregate, an average of \$25 for each dwelling unit in the building. There is no requirement that the owner actually paid the property tax; the requirement is that the owner must not be in arrears.

Qualified homeowners usually pay their property taxes quarterly or semiannually based on New York City's fiscal year end of June 30. They generally file their federal income tax returns on a calendar year basis using the cash receipts and disbursements method of accounting. Depending on their circumstances, most qualified homeowners will fall into one of four situations:

(1) Taxpayers who claimed the standard deduction on their prior year federal income tax return and on their current year federal income tax return;

(2) Taxpayers who claimed an itemized deduction for real property taxes on their prior year federal income tax return and claimed the standard deduction on their current year federal income tax return;

(3) Taxpayers who claimed the standard deduction on their prior year federal income tax return and claimed an itemized deduction for real property taxes on their current year federal income tax return; or

(4) Taxpayers who claimed an itemized deduction for real property taxes on their prior year federal income tax return and on their current year federal income tax return.

The City Council determined that a 2004-05 fiscal year increase in real property taxes was not required. Accordingly, the City Department of Finance determined eligibility for the real property tax rebate and in October and November of 2004 issued rebate checks for the 2003-04 fiscal year to qualified homeowners.

In a telephone conversation, the field counsel attorney assigned to this request informed the National Office that there was no question that the New York City real property tax rebate provided by § 11-239 of the Administrative Code was properly

characterized as a rebate of New York City real property taxes. Thus, for purposes of this memorandum, we assume that the rebate is in fact a rebate of real property taxes previously assessed by the city.

LAW AND ANALYSIS

Section 61(a) 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.

Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by chapter 1 of subtitle A.

In *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983), 1983-1 C.B. 50, the Supreme Court of the United States explained the tax benefit rule. Specifically, the tax benefit rule is a judicially developed principle that modifies the annual accounting doctrine under certain circumstances. The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. *Id.* at 383. The tax benefit rule will “cancel out” an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based. *Id.*

Section 164(a)(1) provides, in part, the general rule that, except as otherwise provided in § 164, state and local real property taxes shall be allowed as a deduction for the taxable year within which paid or accrued.

In general, a taxpayer who receives a rebate of state taxes previously deducted on a prior year's federal income tax return must include the rebate in gross income in the year received to the extent of any federal income tax benefit, in accordance with § 111. A taxpayer who receives a rebate of state taxes that were not previously deducted on a prior year's federal income tax return is not required to include the rebate in gross income in the year received. See Rev. Rul. 93-75, 1993-2 C.B. 63. *Cf.* Rev. Rul. 79-315, 1979-2 C.B. 27; Rev. Rul. 70-86, 1970-1 C.B. 23. In either case, however, a taxpayer must include the rebate of state taxes in gross income to the extent that it exceeds property taxes actually paid by the taxpayer. See, e.g., Rev. Rul. 78-194, 1978-1 C.B. 24.

In Rev. Rul. 70-86, the Internal Revenue Service addressed the tax treatment of rebates of California real property taxes under a prior version of § 111. In an amendment to the California Constitution, eligible taxpayers would receive a relief payment in 1969 for real property tax assessed for the 1968-69 fiscal year if they filed a claim for the real property tax relief payment in 1969. The revenue ruling holds that for purposes of a taxpayer who uses the cash receipts and disbursements method of accounting and who files its return on a calendar year basis, a recovery of the tax previously paid is

excludable from gross income to the extent that the underlying real property tax deduction did not result in a tax benefit for the prior year. Further, the revenue ruling provides that when the prior year's real property tax is paid in installments over 2 years, the relief payment is attributable to each such year in a manner proportionate with the installments made during such years. Moreover, if the taxpayer has not yet paid the real property tax, then the relief payment is in the nature of a reduction of the amount of tax to be paid.

The revenue ruling applies these rules to four situations similar to those presented in your request. The analysis of each situation in the revenue ruling varies depending on whether the taxpayer pays the real property tax in the prior year, pays the real property tax in installments over the prior and current year (i.e., the year that the rebate is received), or does not pay the real property tax. Similar variations are addressed below.

In each situation below, we assume that the individual taxpayers use the cash receipts and disbursements method of accounting and file their tax returns on a calendar year basis. Applying the law and analysis discussed above to the situations presented, we conclude as follows:

Situation 1 - Standard deduction claimed in the prior and current year.

If the standard deduction was claimed in both taxable years, whether the entire real property tax was paid in the prior year, in the current year, or part paid in the prior year and part paid in the current year, the rebate is not includible in gross income under the tax benefit rule because the taxpayer received no tax benefit. See Situation 2(a) of Rev. Rul. 70-86. A tax benefit would have resulted if the taxpayer had taken an itemized deduction for the real property tax. With a standard deduction, there is no specific deduction for real property taxes; therefore, the taxpayer did not receive a tax benefit. However, if the rebate exceeds the amount of real property tax paid, then the excess is includible in gross income. See Rev. Rul. 78-194.

Situation 2 - Itemized deductions claimed in the prior year, and the standard deduction claimed in the current year.

(a) Entire real property tax was paid in the prior year:

If an itemized deduction for real property tax was claimed in the prior year and the real property tax was entirely paid in that taxable year, the rebate received in the current year is includible in gross income to the extent of the prior tax benefit resulting from the deduction of the real property tax payment. See § 111.

(b) Entire real property tax was paid in the current year:

Because the taxpayer's itemized deductions in the prior year were not affected by the payment of the real property tax in the current year, the rebate is not includible in gross income under the tax benefit rule. However, the amount of the rebate reduces the

amount of real property tax paid in the current year. See Situation 4(c) of Rev. Rul. 70-86.

(c) Part of the real property tax was paid in the prior year and the remaining part was paid in the current year:

If part of the real property tax was paid in the prior year and part in the current year, then the rebate must be apportioned over the 2 years with respect to the actual amounts paid in each year. The portion of the rebate attributable to the prior year is includible in gross income for the current year to the extent of the prior year's tax benefit resulting from the deduction of the portion of the taxes paid in that year. The remaining portion of the rebate attributable to the current year is not includible in the current year's gross income but rather reduces the amount of real property tax paid. See Situation 4(b) of Rev. Rul. 70-86.

Under all three of these variations, if the rebate exceeds the property tax paid, the excess is includible in gross income. See Rev. Rul. 78-194.

Situation 3 - Standard deduction claimed in the prior year, and itemized deductions claimed in the current year.

(a) Entire real property tax was paid in the prior year:

If the taxpayer claimed the standard deduction in the prior year, then the rebate is not includible in gross income because there was no tax benefit in the prior taxable year. See Situation 3(a) of Rev. Rul. 70-86.

(b) Entire real property tax was paid in the current year:

If the taxpayer claimed the standard deduction in the prior year, then the rebate is not includible in gross income for the current year. However, the amount of the rebate will reduce the deduction allowable under § 164 for real property tax paid in the current year. See Situation 3(c) of Rev. Rul. 70-86.

(c) Part of the real property tax was paid in the prior year and the remaining part was paid in the current year:

If the standard deduction was claimed in the prior year, but an itemized deduction for real property tax is claimed in the current year, the rebate must be apportioned in proportion to the property tax paid in the prior and current years. The portion of the rebate attributable to the prior year property tax paid is not included in the current year's gross income because the property tax payment created no tax benefit in the prior year. The remaining portion of the rebate is not includible in the taxpayer's gross income for the current year, but rather serves to reduce the deduction allowable under § 164 for real property tax paid in the current year. See Situation 3(b) of Rev. Rul. 70-86.

Under all three of these variations, if the rebate exceeds the property tax actually paid, then the excess must be includible in gross income. See Rev. Rul. 78-194.

Situation 4 - Itemized deductions claimed in the prior and current year.

(a) Entire real property tax was paid in the prior year:

If an itemized deduction was taken in the prior year for the real property tax, the rebate received in the current year is includible in gross income in the current year to the extent of the tax benefit resulting from the deduction of the real property tax in the prior year. See Situation 1(a) of Rev. Rul. 70-86.

(b) The real property tax was paid in the current year:

Because the taxpayer's itemized deductions in the prior year were not affected by the payment of the real property tax in the current year, the rebate is not includible in gross income under the tax benefit rule. However, the rebate serves to reduce the allowable real property tax deduction for the current year. See Situation 1(c) of Rev. Rul. 70-86.

(c) Part of the real property tax was paid in the prior year and the remaining part was paid in the current year:

If an itemized deduction was claimed in the prior year for the amount of real property tax paid in that year, the rebate must be apportioned over the 2 years with respect to the actual tax paid. The portion of the rebate attributable to the property tax paid in the prior year is includible in the taxpayer's gross income for the current year to the extent of the tax benefit resulting from the deduction in the prior year. The remaining portion of the rebate attributable to the property tax paid in the current year is not includible in gross income for the current year, but rather serves to reduce the allowable real property tax deduction for the current year. See Situation 1(b) of Rev. Rul. 70-86.

Under all three variations, if the rebate exceeds the actual real property tax paid, the excess must be included in gross income. See Rev. Rul. 78-194.

We note that, under certain circumstances, a taxpayer's itemized deductions, including a deduction for real property taxes, may be reduced in accordance with the overall limitation on itemized deductions under § 68(a). Rev. Rul. 93-75, 1993-2 C.B. 63, provides guidance on the application of the tax benefit rule in situations in which a

taxpayer's itemized deductions in a prior taxable year were reduced by the limitation in § 68(a) and the taxpayer subsequently recovers all or a portion of the previously deducted amount.

We hope that this memorandum is helpful.