



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

The Honorable Kris Mayes
Attorney General
State of Arizona
2005 North Central Avenue
Phoenix, AZ 85004-1592

Dear Attorney General Mayes:

Thank you for your letter dated January 25, 2024, expressing your concern regarding the Internal Revenue Service (IRS) determination that the 2023 Arizona Families Tax Rebate payments constitute income to the recipients for federal income tax purposes. We received similar letters from Arizona Senate President Petersen and United States Senator Sinema.

I take very seriously the issues you have raised with me and the potential implications for taxpayers who receive these state tax rebates. I am committed to providing clear guidance for taxpayers doing their best to fulfill their tax obligations.

To that end, the IRS has been diligently working through the issues raised by certain types of state payments over the past year. Below I outline our recent work on these issues.

Last February, we provided broad administrative relief for state payments made in 2022 because it was the middle of filing season and numerous states had adopted a variety of payment programs requiring a fact-intensive analysis to determine whether they qualified for an exclusion. (IR-2023-23, Feb. 10, 2023.) We provided this administrative relief on an expedited basis in order to provide taxpayers the certainty they needed to be able to file their returns without undue delay. This did not reflect a legal determination as to the proper treatment for each of the payments. The announcement made clear that this administrative relief applied only for payments made in 2022.

In August, we issued published guidance explaining how the IRS treats various types of state payments. (Notice 2023-56.) This guidance included a discussion of the general welfare exclusion as well as the treatment of payments that are properly characterized as income tax refunds. The notice also explained that the label given to a payment under state law is not controlling for federal tax purposes. Rather, federal tax law looks

to the substance of the payment to determine its purpose and federal income tax characterization. See Notice 2023-56, section 3.02 (citing authorities).

Generally, under § 61 of the Internal Revenue Code, gross income includes all income from whatever source derived unless an exception applies. In your letter, you suggest that the general welfare exception is applicable to the 2023 Arizona Families Tax Rebate payments and, alternatively, that these payments constitute refunds of income tax paid by the recipients. After consulting again with our Office of Chief Counsel, I can confirm that we stand by our conclusion that neither exception applies. The paragraphs below reflect Chief Counsel's analysis of the issues.

For payments to be excluded under the general welfare exclusion, the payments must be made from a government fund, be for the promotion of general welfare (based on individual or family need), and not be compensation for services. The general welfare exclusion is generally limited to payments made pursuant to a program limited to low-income recipients. See Notice 2023-56; Revenue Ruling 78-170; Revenue Ruling 76-395. The 2023 Arizona Families Tax Rebate payments do not meet the standards for this exception for two reasons: First, the income limitations for the payments are above the limit of what we generally consider to be covered by the general welfare exclusion. Eligibility for the payments begins to phase out at \$400,000 for married taxpayers filing jointly and \$200,000 for all other filers. Those amounts represent multiples of the median adjusted gross income (AGI) for Arizona filers (\$30,000 single, \$94,000 married filing jointly for 2021). In addition, 98% of Arizona single filers had AGI below \$200,000 and 95% of married joint filers had AGI below \$400,000 in 2021. Second, Arizona residents that had no tax liability in 2019-2021 were not eligible to receive a payment. As a result, residents with income below the Arizona standard deduction did not receive a payment. This group includes single residents with income below \$12,550 and married couples with income below \$25,000. Thus, rather than targeting relief to low-income residents with dependents, the legislation expressly excludes such low-income residents from receiving the payments while including almost all similarly situated Arizonans with higher incomes. Consequently, the payments are not based on need and do not qualify for the general welfare exception.

Notice 2023-56 also explained that for payments to be treated as income tax refunds, the payment must be limited to the amount of tax the taxpayer previously paid. See Notice 2023, section 3.02. The notice further explained that if a payment is properly characterized as an income tax refund, it is generally not includable in income because it is merely a return of an overpayment to the taxpayer and is not an accession to wealth. However, if the taxpayer previously deducted the amount refunded, the taxpayer must include the refund in income for federal tax purposes to the extent the taxpayer received a tax benefit from the prior deduction of the refunded amount.

The 2023 Arizona tax rebates are not refunds of taxes previously paid for federal tax purposes because the amount paid to taxpayers is not capped at the amount of tax previously paid. In your letter, you suggest that the Tax Court's decision in *Maines v.*

Commissioner, 144 T.C. 136 (2015), which Notice 2023-56 cites as authority, requires treating the 2023 Arizona tax rebates as a tax refund to the extent the recipient had previously paid Arizona income taxes. The language you quote from *Maines* was describing the treatment of refundable state credits, not refunds, and stands for the proposition that gross income does not include a refundable state tax credit to the extent it merely reduces present-year tax liability. That proposition applies only to tax credits and has no relevance to the 2023 Arizona tax rebates, which were cash payments.

Maines also rejected the taxpayer's argument that the state law characterization of the credits as refunds controls for federal income tax purposes and held that two credits that were not limited to the amount of taxes previously paid by the taxpayers did *not* constitute refunds for federal income tax purposes. Only the third credit, which was so limited, was properly treated as a refund for federal income tax purposes. Thus, *Maines* is consistent with our analysis.

Regarding the status of the tax rebate payments as refunds, you seem to characterize the IRS's position on refund status as requiring that the taxpayer establish that they have not previously deducted their state tax payment for federal tax purposes. That statement reflects a misunderstanding. A payment's status as a refund is not dependent on whether a taxpayer has previously deducted a state tax payment. Rather, that factor goes to whether the taxpayer has received a federal tax benefit from the prior deduction, which may require the taxpayer to include all or part of the refund in income in the year in which the refund is received. See section 3.02 of Notice 2023-56. That is a determination that is made on a taxpayer-by-taxpayer basis, whereas the status of a payment as a refund applies with respect to all taxpayers who receive the payment.

I appreciate your concern on behalf of Arizona taxpayers. I wish to assure you that it is the IRS's priority to ensure that the rules concerning income inclusion and exclusion are applied fairly and consistently to every state payment and that the IRS is applying the rules reflected in this letter and in Notice 2023-56 to similar programs in other states as well as to Arizona.

If you have questions, please contact me, or a member of your staff may contact Brytten Rice, Program Manager, Privacy, Governmental Liaison and Disclosure, at (763) 347-7366.

Sincerely,

Daniel I. Werfel
Commissioner