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LEGAL RULING 2001-3

CALIFORNIA TAX CONSEQUENCES OF FEDERAL ADVANCE REFUNDS AND CREDITS PROVIDED BY INTERNAL REVENUE CODE SECTION 6428

PURPOSE

The purpose of this ruling is to provide guidance to taxpayers concerning the California tax treatment of federal income tax credits and refunds under newly enacted Internal Revenue Code section 6428.

ISSUE

Is the federal advance refund or tax credit under Internal Revenue Code section 6428 subject to California income tax?

FACTS

Situation 1: Taxpayer X, an unmarried individual California taxpayer, has federal taxable income in excess of \$6,000 and a federal income tax liability in excess of \$300 for the 2000 taxable year. In September of 2001, X receives a \$300 advance refund check pursuant to Internal Revenue Code section 6428.¹ X has federal taxable income in excess of \$6,000 and a federal income tax liability in excess of \$300 for the 2001 taxable year.

Situation 2: Same facts as Situation 1, except X has no federal taxable income and no federal income tax liability for the 2001 taxable year.

Situation 3: Same facts as Situation 1, except X has no federal taxable income and no federal income tax liability for the 2000 taxable year, so that X does not receive an advance refund check in 2001. X has federal taxable income in excess of \$6,000 and a federal income tax liability in excess of \$300 for the 2001 taxable year. X claims a \$300 credit for the 2001 taxable year.

LAW AND ANALYSIS

Internal Revenue Code section 6428, enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub.L. No. 107-16, § 101(b) (June 7, 2001) 115 Stat. 38, 42), allows an eligible individual (an individual other than an estate or trust, a

¹ The filing status of the taxpayer determines the maximum amount of the credit that can be claimed as discussed in Law and Analysis.

nonresident alien individual or someone who can be claimed as a dependent by someone else) a credit against the individual's federal income tax liability for the first taxable year beginning in 2001 in an amount equal to 5 percent of the individual's taxable income (up to a maximum credit of 5 percent of the initial bracket amount), limited to the individual's regular tax liability for 2001 reduced by nonrefundable credits. (Int.Rev. Code § 6428(a), (b).) The maximum amount of credit that an individual may claim is \$600 in the case of married individuals filing a joint return or an unmarried individual filing as a surviving spouse, \$500 in the case of an individual filing as head of household, and \$300 in the case of married individuals filing separately and unmarried individuals not filing as head of household or surviving spouse.

Although the credit is allowed for the taxable year beginning in 2001, Internal Revenue Code section 6428(e) provides for an advance refund in 2001 for individuals that were eligible individuals for the first taxable year beginning in 2000. The amount of the advance refund is equal to the credit that would have been allowed if the law had applied to taxable year 2000. The amount of the advance refund reduces the amount of credit allowed for the taxable year 2001. The eligible individual is treated as having made a payment for the 2000 federal income tax liability equal to the advance refund amount. (Int.Rev. Code, § 6428(e)(1).) Because the tax liability for 2000 is not adjusted, the individual has an overpayment that is refunded via the advance refund. (Int.Rev. Code, § 6428(e)(3), (4).)

If an individual had no federal income tax liability for 2000, then, for purposes of calculating that individual's entitlement to receive an advance refund, the credit amount would be zero and the individual would not receive an advance refund. If that individual, however, has a federal income tax liability for 2001, then the individual may claim the credit on the return for 2001. The amount of credit claimed for 2001 would not be reduced since there was no advance refund. If an individual had federal income tax liability for 2000 that is less than the maximum amount of the credit (and advance refund) allowed and the individual has federal income tax liability in 2001 in excess of the minimum amount, then the individual will have a credit for 2001. The credit for 2001 would be reduced, but not below zero, by the amount of the advance refund.

California has not conformed to, incorporated or otherwise adopted language identical or similar to Internal Revenue Code section 6428. California does, however, conform to Internal Revenue Code section 61 and the general tax concepts of what items constitute gross income. (Rev. & Tax. Code, § 17071.)

The advance tax refund is considered to be an overpayment of federal income tax. (Int.Rev. Code § 6428(e)(3), (4).) Refunds or abatements of federal income taxes constitute a return of capital. (*Emmet v. Commissioner* (1948) 11 T.C. 90; Gen. Couns. Mem. 39,697 (August 9, 1987).) The return of capital does not constitute income, as there is no economic gain or accession to wealth. (*The Home Savings and Loan Company v. Commissioner* (1962) 39 T.C. 368.) Moreover, the tax benefit rule ((Int.Rev. Code § 111, as incorporated by reference into California personal income tax law under

Rev. & Tax. Code, § 17131) does not require the refund be taken into income because the amount refunded was never deducted under California law.²

The same analysis holds true where the taxpayer receives a credit against his or her federal income tax liability instead of a cash refund. The limitations on the amount of the refund or credit allowed always result in the amount of the refund or credit never exceeding the individual's tax liability for the year of refund or credit.³ Thus, an individual will never receive back, in cash or as a credit, more than what that individual actually paid or was required to pay in tax for that year.

HOLDING

Situation 1: The advance refund of the federal tax credit provided under Internal Revenue Code section 6428 is not includible in California taxable income by X.

Situation 2: The advance refund of the federal tax credit provided under Internal Revenue Code section 6428 is not includible in California taxable income by X.

Situation 3: The credit claimed by X under Internal Revenue Code section 6428 is not includible in California taxable income by X.

DRAFTING INFORMATION

The principal author of this ruling is Debra S. Petersen of the Franchise Tax Board, Legal Branch. For further information regarding this ruling, contact Ms. Petersen at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720.

² Some states allow a deduction of federal income taxes for purposes of computing state taxable income. In that case, the advance refund may be required to be taken into taxable income for that state.

³ A similar state statute that provided for rebates was examined in Revenue Ruling 79-315, 1979-2 C.B. 27. A difference in the tax treatment arises, however, because federal income tax law permits the deduction of state taxes while federal taxes are not deductible for either California or federal income tax purposes. Moreover, the federal law analyzed herein limits the amount of the refund so that a taxpayer will never receive a refund in excess of the taxpayer's tax liability for the year 2000.