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ATTORNEY GENERAL

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STATE OF ARIZONA

January 25, 2024

VIA MAIL

The Honorable Daniel Werfel
Commissioner, Internal Revenue Service
Internal Revenue Service Building
1111 Constitution Ave., NW
Washington, D.C. 20224

Re: Federal taxation of Arizona's General Welfare Income Tax Rebate.

Dear Commissioner:

I write regarding the Internal Revenue Service's determination that Arizona's General Welfare Income Tax Rebate ("Tax Rebate") is subject to federal taxation. I understand that the IRS announced this determination orally in a meeting with attorneys from the Arizona Department of Revenue and that the IRS may release its written guidance concerning 2023 state tax rebates next month. This determination—as we understand it absent written guidance—appears to contradict the IRS's recent decisions concerning similarly situated state programs and taxpayers, and to be highly arbitrary.

Under the IRS's 2023 guidance, the Tax Rebate should be excludable from federal income under the general welfare exclusion—or, at a minimum, it should be excludable to the extent a Rebate amount does not exceed state taxes that a taxpayer actually paid and did not deduct from his or her federal income.

The Arizona Department of Revenue has already [alerted](#) Arizona taxpayers that the Tax Rebate is subject to federal income tax in reliance on the IRS's erroneous oral determination. Because taxpayers are now preparing their 2023 tax returns to meet the April 15 filing deadline, it is critical that the IRS correct or clarify this determination as soon as possible, as further set forth below.

A. The full Tax Rebate should be excludable from federal tax under the general welfare exclusion.

Arizona's Tax Rebate was "a onetime income tax general welfare rebate" available to taxpayers who paid Arizona taxes in 2019, 2020, or 2021 and claimed at least one dependent in 2021. [S.B. 1734](#), 56th Leg., 1st Reg. Sess. (May 12, 2023). The rebate was \$250 for each

dependent under age seventeen and \$100 for dependents age seventeen or older, capped at \$750 per taxpayer. (*Id.*; *see also* Arizona Department of Revenue, [Arizona Families Tax Rebate](#).)

IRS Notice [2023-56](#) established (at p. 5) that “payments made to, or on behalf of, individuals by governmental units under legislatively provided social benefit programs for the promotion of the general welfare are not includible in an individual recipient’s Federal gross income.” As the IRS further explained, “[t]o qualify for the general welfare exclusion, State payments must (1) be paid from a governmental fund, (2) be for the promotion of general welfare (that is, based on the need of the individual or family receiving such payments), and (3) not represent compensation for services absent a specific Federal income tax exclusion.” *Id.* at 6.

The Tax Rebate unquestionably satisfied the first and third prongs of this test because it was paid out of Arizona’s general fund to qualifying Arizonans, not as compensation for services. It also satisfied the second prong because it was not available to all Arizonans or an undifferentiated class of Arizonans, but rather only to Arizonans (1) with dependents; who (2) claimed a Dependent Tax Credit (a de facto income cap), thereby establishing two measures of need. *See* S.B. 1734, 56th Leg., 1st Reg. Sess. (May 12, 2023); A.R.S § 43-1073.01.

With these qualifying criteria, Arizona’s Tax Rebate was more targeted to individual need than several other state payments and rebates that the IRS determined to be excludable from federal tax in February 2023. *See* [IR-2023-23](#). Based on our review, the programs in at least Alaska, Colorado, Delaware, Idaho, and Indiana did not appear to contain *any* income qualification whatsoever. Likewise, California’s program was overtly labeled a “Middle Class Tax Refund” and was available to taxpayers with incomes up to \$500,000. (State of California Franchise Tax Board, [Middle Class Refund](#).)

The IRS did not distinguish between the “general welfare” and “disaster relief” (COVID-related)¹ exclusions in making these determinations, but these programs were generally indistinguishable from Arizona’s Rebate except insofar as they were less restrictive. Colorado, for example, called its program “Colorado Cash Back” and issued payments to all Colorado residents over age eighteen who had filed a state income tax return in 2021. (Colorado Department of Revenue, [Colorado Cash Back](#).) Colorado, moreover, made explicitly clear that it was issuing payments pursuant to its Taxpayer Bill of Rights, which “limits the amount of revenue the state may retain and spend in each state fiscal year.” (*Id.*; *see also*, e.g., Idaho State Tax Commission, *2022 Tax Rebates: Frequently Asked Questions* (providing that “[a]ny Idahoan who was a full-year resident in 2020 and 2021 and who also filed an Idaho individual income tax return . . . for those years is eligible for” Idaho’s rebate). Likewise, California’s middle-class refunds were generally available to all residents who fell within the program’s expansive income range and could not be claimed as dependents.

In finding payments under these programs excludable from federal tax, the IRS stated that it considered “the best interest of sound tax administration” and “the fact that the pandemic

¹ Under the IRS’s guidance, a payment must be made “in connection with a qualified disaster” to qualify for the disaster relief exclusion. Notice 2023-56 at 6-7.

emergency declaration is ending in May, 2023 making this an issue only for the 2022 tax year.” IR-2023-23. But the pandemic emergency declaration appears to have had *no* material bearing on the programs in California, Colorado, Idaho, and elsewhere. And while sound tax administration is always desirable, it is not a license to treat similarly situated states and taxpayers differently (or arbitrarily) based on unrelated national exigencies that happen to roughly coincide with a particular program. After all, sound tax administration depends not merely on administrative convenience, but also on consistency, fairness, and predictability. (See, e.g., IRS, [The Agency, Its Mission and Statutory Authority](#) (IRS mission includes “fairness to all”).) And these considerations should carry particular weight with respect to a state law—like the Tax Rebate—that was enacted just a few months after the IRS had made determinations about materially similar programs. See IR-2023-23 (issued February 2023).

B. At a minimum, the Tax Rebate should be excluded from federal tax to the extent it does not exceed state taxes that were actually paid and that were not deducted from federal income.

Notice 2023-56 also established (at p. 4) that “State payments that are properly treated as State tax refunds generally are not includible in the recipient’s Federal gross income because, as the return of an overpayment of the recipient’s State tax liability, these refunds are not an accession to wealth.” According to the IRS’s further guidance, such payments will therefore not be subject to federal taxation where (1) the refund is for “State taxes actually paid by the taxpayers”; and (2) the taxpayer has not deducted those state taxes for federal tax purposes in a prior taxable year (e.g., because the taxpayer took the standard federal deduction). *Id.* at 3-4.

This determination mirrored the IRS’s earlier guidance that “[i]f the payment is a refund of state taxes paid and either the recipient claimed the standard deduction or itemized their deductions but did not receive a tax benefit (for example, because the \$10,000 tax deduction limit applied) the payment is not included in income for federal tax purposes.” IR-2023-23. The IRS therefore found that payments by four states (Georgia, Massachusetts, South Carolina, and Virginia) fell within this category and would “be excluded from income for federal tax purposes unless the recipient received a tax benefit in the year the taxes were deducted.” *Id.*

At a minimum, Arizona’s Tax Rebate falls directly within this determination and should not be subject to federal taxation to the extent individual taxpayers meet both criteria. While the Tax Rebate is not strictly limited to state taxes actually paid, it is available only to those who paid at least \$1 in taxes; thus, every taxpayer who received the Tax Rebate should be eligible to exclude at least a portion of it from federal taxable income, provided that the taxpayer did not deduct his or her state taxes from federal income.

Indeed, it is hard to fathom any reasoned basis to conclude otherwise. If the IRS’s position to the contrary is based on Arizona’s decision not to statutorily limit the Rebate to taxes actually paid, that is contrary to the authority on which Notice 2023-56 relied. See *Maines v. Comm’r*, 144 T.C. 123, 136 (2015) (holding that only the “*excess portion*” of a tax refund “that remains after first reducing state-tax liability . . . is an accession to the [taxpayer’s] wealth, and [includable] in . . . federal gross income”) (emphasis added).

It is also both inequitable and arbitrary. It is inequitable because approximately 75% of Arizonans who received a Tax Rebate payment had a tax liability in excess of the Rebate amount.² Thus hundreds of thousands of Arizona taxpayers who paid state tax in excess of the Tax Rebate—and who did not deduct state taxes on their federal return—will nonetheless be federally taxed on the Rebate in violation of the IRS’s own criteria. And many more Arizonans will be federally taxed on the entire Rebate, even though they paid at least some state taxes in an eligible year.

Likewise, the determination is arbitrary because the tax laws are replete with provisions allowing or disallowing deductions, credits, etc., *to the extent* other criteria are met. Indeed, to our knowledge, none of the states that received the benefit of the IRS’s determination last year have incorporated the second prong of the IRS’s test into their state laws—i.e., they have not required taxpayers to establish that they have claimed the standard federal deduction (or that they otherwise have not deducted their state taxes from federal income) as a condition of receiving a payment. The two requirements—that state taxes were actually paid and that they were not federally deducted—are functionally identical in kind, insofar as the IRS has overlaid both conditions over state law for federal tax purposes. It therefore should be irrelevant whether states have conditioned the actual payments on either or neither condition under their state laws.

We appreciate that the IRS is frequently asked to make difficult, fact-sensitive determinations, but the IRS made the relevant determinations concerning state payment programs in February 2023, shortly before Arizona enacted the Tax Rebate. It would therefore also be fundamentally arbitrary and inequitable to preclude Arizona and its taxpayers from relying on that guidance, particularly given the materially similar (and less restrictive) state programs that the IRS found to be nontaxable in whole or in part last year.

Please respond to this letter—either by return letter or through amended published guidance—no later than February 6, 2024. If we are not able to satisfactorily resolve this issue by then, I will consider all possible avenues for potential legal action on behalf of the State and its taxpayers in advance of this year’s tax filing deadline. Thank you for your attention to this important and time-sensitive matter.

Sincerely,



Kris Mayes
Attorney General

² Arizonans who have claimed a Rebate payment had an average tax liability of about \$1,700 in the year for which the Rebate was claimed, against an average Rebate amount of \$370.