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19 **UNITED STATES DISTRICT COURT**
20 **DISTRICT OF ARIZONA**

21 State of Arizona,

22 Plaintiff,

23 v.

24 United States Internal Revenue Service;
25 Daniel I. Werfel, in his official capacity as
26 Commissioner of the United States Internal
27 Revenue Service; the United States
28 Department of Treasury; Janet L. Yellen, in
her official capacity as Secretary of the
United States Department of Treasury; and
the United States of America,

Defendants.

No.

**COMPLAINT FOR
DECLARATORY AND
INJUNCTIVE RELIEF**

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INTRODUCTION

1. The State of Arizona, like other states, operates under persistent budgetary constraints and must constantly weigh the relative merits of alternative policy approaches. When Arizona’s elected leaders chose to refund tax revenue to Arizona taxpayers last year, their reasonable expectation was therefore that the money would go *to Arizona taxpayers, not to the Internal Revenue Service*—but the IRS had a different idea. With this action, the State of Arizona, through Attorney General Kris Mayes, seeks declaratory and injunctive relief to enjoin the IRS from unlawfully taking a cut of tax revenue that belongs to Arizona and its taxpayers.

2. In May 2023, the State of Arizona enacted into law a one-time General Welfare Income Tax Rebate (“Tax Rebate”), which returned tax revenue to taxpayers who (a) had dependents; (b) had met the income threshold to claim the Dependent Tax Credit; and (c) had paid state income tax in a year between 2019 and 2021.

3. In February 2023, just a few months before Arizona opted to enact the Tax Rebate, the IRS had issued “guidance on state tax payments to help taxpayers” in which it determined that similar rebates and payments issued by *seventeen* other states in 2022 were not subject to federal income tax based on applicable exclusions. The IRS also determined that refunds by an additional four states were generally nontaxable for the simple reason that refunds of taxes actually paid are not considered “income.”

4. Many of these rebate and payment programs were materially similar to Arizona’s, and some were unequivocally less targeted at individual or family need. One state, for example, had issued payments to all residents over age eighteen who had filed a state income tax return in the preceding year.

1 5. Arizona’s reasonable expectation was therefore that every dime it returned
2 to Arizona taxpayers would stay in their pockets, to be spent or otherwise enjoyed as
3 they saw fit. And of course, a portion of this money would then end up back in State
4 coffers via transaction privilege taxes (commonly referred to as sales taxes) and other
5 State taxes.
6

7 6. Instead, the IRS declared that the Tax Rebate payments were taxable in
8 full by the federal government.
9

10 7. This determination was contrary to law and in violation of the IRS’s most
11 recent guidance finding state tax refunds nontaxable on multiple grounds.
12

13 8. Arizona seeks declaratory and injunctive relief to enjoin the IRS from
14 enforcing its unlawful, inequitable, and arbitrary determination, and to refund amounts
15 that have been unlawfully collected from Arizona taxpayers.
16

JURISDICTION AND VENUE

17 9. The Court has jurisdiction over the action under 28 U.S.C. §§ 1331 and
18 1340.
19

20 10. Venue is proper in this district pursuant to 28 U.S.C. § 1391(b)(2) and §
21 1391(e)(1)(B).
22

PARTIES

23 11. Attorney General Kris Mayes brings this action on behalf of the State of
24 Arizona to protect the interests of Arizona and its taxpayers. The Attorney General is
25 the chief law officer of the State and is authorized to file civil suits directly involving
26 the State’s rights and interests. A.R.S. § 41-193(A)(3).
27
28

1 19. The IRS determined that taxpayers in seventeen states did not need to
2 report state refunds and payments on their 2022 federal tax returns.

3 20. The IRS did not identify the precise bases for these determinations, but
4 stated that “[i]f a payment is made for the promotion of the general welfare or as a
5 disaster relief payment, for example related to the outgoing pandemic, it may be
6 excludable from income for federal tax purposes under the General Welfare Doctrine or
7 as a Qualified Disaster Relief Payment.”
8

9 21. The IRS further stated that “[d]etermining whether payments qualify for
10 these exceptions is a complex fact intensive inquiry that depends on a number of
11 considerations.”
12

13 22. The plain implication of the IRS’s statements was that the IRS endeavored
14 to make reasoned determinations and to treat similarly situated states and taxpayers in a
15 similar manner.
16

17 23. In explicitly stating that a pandemic-related payment was only an
18 “example” of a nontaxable payment, the IRS plainly established that a direct connection
19 to the pandemic was not a necessary condition for a payment to qualify for the general
20 welfare exclusion and be nontaxable.
21

22 24. The IRS also stated that irrespective of any applicable exclusion, a tax
23 refund is nontaxable if it is a refund of state taxes paid and the recipient either claimed
24 the standard deduction or itemized his or her deductions but did not receive a federal tax
25 benefit.
26

27 25. The IRS found that payments by four additional states (Georgia,
28 Massachusetts, South Carolina, and Virginia) were nontaxable on this basis.

1 26. The IRS therefore determined that the rebates and payments in all 21
2 states it analyzed were nontaxable in whole or in part.

3 27. IR-2023-23 did not determine that any of the 21 payments it examined
4 were taxable in whole.
5

6 **B. Arizona enacts a one-time Tax Rebate.**

7 28. In May 2023, Arizona enacted into law the Arizona Tax Rebate, in
8 reliance on the IRS’s February 2023 determinations.
9

10 29. Arizona’s Tax Rebate was “a onetime income tax general welfare rebate”
11 available to taxpayers who paid Arizona taxes in 2019, 2020, or 2021, and claimed at
12 least one dependent in 2021.

13 30. The Rebate was \$250 for each dependent under age seventeen and \$100
14 for dependents age seventeen or older, capped at \$750 per taxpayer.
15

16 31. The Tax Rebate was disbursed out of Arizona’s general fund to qualifying
17 Arizonans; it was not paid as compensation for services.

18 32. Arizona enacted the Tax Rebate at a time when the COVID-19 emergency
19 declaration was still in effect.
20

21 33. In passing the Tax Rebate, Arizona’s Legislature specifically found that
22 “[i]nflation is at a forty-year high, putting gas, groceries and other necessities out of
23 reach for many Arizonans. . . . Responsible budgeting has allowed this state to take
24 action to mitigate the harmful impacts of inflation by returning a portion of the surplus
25 to this state’s taxpayers with dependents.”
26
27
28

1 34. The Tax Rebate was not available to all Arizonans or to an
2 undifferentiated class of Arizonans. Rather, it was available only to Arizonans (i) with
3 dependents; who (ii) claimed a Dependent Tax Credit (a de facto income cap).
4

5 35. These criteria, separately and in conjunction, established a measure of
6 need among taxpayers who claimed the Tax Rebate.

7 **C. The IRS affirms its February 2023 guidance.**

8 36. In August 2023, the IRS issued Notice 2023-56 to “describe[] the rules
9 that the [IRS] applies in determining the federal income tax consequences of refunds of
10 State or local taxes and certain other payments made by State or local governments . . .
11 to individuals.”
12

13 37. The IRS noted that “[i]n 2022, a number of States implemented programs
14 to provide State payments to certain individuals residing in their States.”
15

16 38. The IRS stated that “[*m*]any of these programs were related, directly *or*
17 *indirectly*, to the various consequences of the Coronavirus Disease 2019 (COVID-19)
18 pandemic, and *the programs varied in terms of the types of payments, payment amounts,*
19 *and eligibility criteria.*” (Emphasis added.)
20

21 39. The IRS thus acknowledged that the 2022 payment programs varied
22 significantly, that some of the programs were only indirectly related to COVID-19, and
23 (by implication) that some were not even indirectly related to COVID-19.
24

25 40. The IRS purported to state that its February 2023 guidance applied only
26 for payments made in 2022. But the IRS did not identify a single program that it had
27 found nontaxable for 2022 but would have found taxable in other years based on the
28 criteria that it enunciated.

1 41. Rather, the IRS explained that payments for the promotion of the general
2 welfare are not includible in the recipient’s federal gross income if the payments are
3 from a governmental fund, are for the promotion of the general welfare, and do not
4 represent compensation for services.
5

6 42. The IRS further explained that payments made in connection with a
7 qualified disaster are presumed to promote the general welfare.
8

9 43. In issuing Notice 2023-56, the IRS sought to establish that its
10 determinations in February 2023 were reasoned and lawful, and that the determinations
11 had a rational nexus to the criteria set forth in Notice 2023-56.
12

13 44. If the IRS believed that it had made unlawful, erroneous, or pretextual
14 determinations in February 2023, it had a duty to say so, so as not to mislead states and
15 taxpayers who would reasonably rely on IR-2023-23 and Notice 2023-56.
16

17 45. In Notice 2023-56, the IRS also affirmed that even if the general welfare
18 exclusion does *not* apply, state tax refunds “generally are not includible in the
19 recipient’s Federal gross income because, as the return of an overpayment of the
20 recipient’s State tax liability, these refunds are not an accession to wealth.”
21

22 46. The IRS reiterated that such payments will not be subject to federal
23 taxation where (1) the refund is for “State taxes actually paid by the taxpayer”; and (2)
24 the taxpayer has not deducted those state taxes for federal tax purposes in a prior taxable
25 year (e.g., because the taxpayer took the standard federal deduction).
26

27 47. The IRS cited *Maines v. Comm’r*, which holds that only the “*excess*
28 *portion*” of a tax refund “that remains after first reducing state-tax liability . . . is an
29

1 accession to the [taxpayer’s] wealth, and [includible] in . . . federal gross income.” 144
2 T.C. 123, 136 (2015) (emphasis added).

3
4 48. In IR-2023-158, an accompanying news release, the IRS reiterated that
5 **“[m]ost taxpayers receiving state tax refunds do not have to include the state tax**
6 **refund in income for federal tax purposes.** As a general rule, taxpayers who choose
7 the standard deduction on their federal income tax returns do not owe federal income
8 tax on state tax refunds.” (Bold in original.)

9
10 49. On its website, the IRS represents to the public that its mission is to
11 **“[p]rovide America’s taxpayers top quality service by helping them understand and**
12 **meet their tax responsibilities and enforce the law with integrity and fairness to all.”**

13
14 50. At a minimum, “fairness to all” must mean that taxpayers and
15 policymakers can confidently rely on the IRS’s recent guidance and that the IRS will
16 apply established taxation laws and principles in a rational and consistent manner.

17
18 51. The IRS recognizes that its recent guidance will carry particular weight
19 for taxpayers and policymakers who are evaluating the tax consequences of matters
20 within the ambit of the guidance.

21
22 52. Several of the 2022 state refund programs that the IRS determined to be
23 nontaxable were objectively less targeted at individual need than Arizona’s Tax Rebate.

24
25 53. The programs in at least Alaska, Colorado, Delaware, Idaho, and Indiana
26 did not contain *any* income qualification whatsoever.

27
28 54. Colorado 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 also made explicitly clear that it was issuing payments pursuant to its

1 Taxpayer Bill of Rights, which “limits the amount of revenue the state may retain and
2 spend in each state fiscal year.”

3
4 55. Idaho made its rebates available to “[a]ny Idahoan who was a full-year
5 resident in 2020 and 2021 and who also filed an Idaho individual income tax return . . .
6 for those years.”

7 56. California called its program a “Middle Class Tax Refund” and made
8 refunds generally available to all residents with incomes up to \$500,000.

9
10 57. Several other payment programs that the IRS determined to be nontaxable
11 were materially comparable to Arizona’s in their qualifying criteria, intent, and effect.

12 **D. The IRS unlawfully declares that the Arizona Tax Rebate is taxable in full,**
13 **harming Arizona and its taxpayers.**

14 58. In December 2023, the IRS informed the Arizona Department of Revenue
15 that—notwithstanding the IRS’s determinations concerning materially similar programs
16 just months earlier—the Arizona Tax Rebate was federally taxable in full.

17
18 59. The IRS announced this decision orally in a video meeting.

19 60. The IRS provided no written explanation regarding the decision until
20 February 15, 2024, in response to a letter from Arizona’s Attorney General challenging
21 the decision.

22
23 61. In the intervening time, the Arizona Department of Revenue had no
24 choice but to convey the IRS’s erroneous decision to Arizona taxpayers and to make
25 Form 1099s available to them to report the purported “income” from the Tax Rebate.

26 62. The IRS’s determination was arbitrary, capricious, inequitable, and
27 unlawful.
28

1 63. In determining that rebates and payments by seventeen states were
2 nontaxable in 2022, the IRS had acknowledged that some of the programs were only
3 indirectly related, or not related at all, to any ongoing national emergency.
4

5 64. In determining that rebates and payments by seventeen states were
6 nontaxable in 2022, the IRS had represented that such determinations were dependent
7 on a complex and fact-intensive inquiry that depends on a number of considerations.
8 But the IRS failed to specify the precise factual or legal analysis on which it made any
9 of the determinations.
10

11 65. Taxpayers and policymakers could therefore only reasonably conclude
12 that similarly situated states would receive similar treatment and would not be
13 discriminated against.
14

15 66. There was no reasoned basis to deprive Arizona and its taxpayers of
16 consistent and equitable treatment, particularly given that the Arizona Tax Rebate—
17 unlike other approved programs—was available only to taxpayers with dependents who
18 met the income requirement to claim a Dependent Tax Credit.
19

20 67. In its February 15, 2024 letter and in a video conference that same day,
21 the IRS reiterated that determining whether payment programs qualify for an exclusion
22 requires “a fact-intensive analysis.” But the IRS also asserted for the first time that its
23 determinations in IR-2023-23 “did not reflect a legal determination as to the proper
24 treatment for each of the payments.”
25

26 68. The February 15, 2024 letter affirmed Notice 2023-56’s guidance “that the
27 label given to a payment under state law is not controlling for federal tax purposes.”
28 Yet in the video conference that same day, the IRS disclosed to the participants that, in

1 fact, the IRS deferred to a state law’s characterization of its payments as being for the
2 purpose of disaster relief, such as COVID-19 relief.

3
4 69. In providing conflicting and evolving rationales for its 2023
5 determinations and for its disparate treatment of Arizona, the IRS has further
6 demonstrated that its determination regarding the Tax Rebate lacks any reasoned
7 justification.

8
9 70. The IRS compounded its unlawful and inequitable determination by
10 refusing even to give Arizona taxpayers the benefit of the established rule that tax
11 rebates are nontaxable to the extent a taxpayer has not federally deducted state taxes and
12 a rebate does not exceed taxes actually paid.

13
14 71. The Tax Rebate was available only to individuals who had paid state tax
15 in the year for which they claimed the Rebate.

16
17 72. Approximately 75% of Arizonans who received a Tax Rebate payment
18 had a tax liability in excess of the Rebate amount. The vast majority of these taxpayers
19 took the standard federal deduction or otherwise did not deduct their state taxes from
20 federal income.

21
22 73. Thus, hundreds of thousands of Arizona taxpayers who paid state tax in
23 excess of the Tax Rebate—and who did not deduct state taxes on their federal returns—
24 are nonetheless being unlawfully subjected to federal income taxation on a payment that
25 is not “income.” And many more Arizonans will be federally taxed on the entire
26 Rebate, even though they paid at least some state taxes in an eligible year.

1 74. The IRS’s determination harmed Arizona taxpayers by compelling them,
2 without lawful basis, to remit an estimated \$20.8 million to the IRS (the “Unlawfully
3 Taxed Amount”).
4

5 75. Absent the IRS’s unlawful determination, Arizona taxpayers would have
6 retained the Unlawfully Taxed Amount to spend as they saw fit.
7

8 76. Absent the IRS’s unlawful determination, Arizona taxpayers would have
9 spent a significant portion of the Unlawfully Taxed Amount in Arizona on goods and
10 services subject to Arizona’s transaction privilege taxes. Arizona taxpayers also would
11 have used the Unlawfully Taxed Amount to pay property, licensing, and other taxes in
12 Arizona.
13

14 77. Arizona’s Department of Revenue calculates that the IRS’s unlawful
15 determination has deprived the State of approximately \$480,000 in State and local
16 transaction privilege tax revenue that would have been derived from taxpayers’
17 spending of the Unlawfully Taxed Amount in Arizona.
18

19 78. Absent the unlawful determination, Arizona taxpayers would have used
20 the Unlawfully Taxed Amount in a manner that promoted Arizona’s economy and their
21 own wellbeing.
22

23 79. Absent the unlawful determination, Arizona would not have been
24 subjected to the administrative and financial burden of (a) providing Form 1099s to
25 taxpayers; (b) communicating the disparate federal treatment of the Tax Rebate to
26 taxpayers; or (c) administering the State’s tax collection in the aftermath of the
27 administrative complexity introduced by different federal and State treatments of the
28 Tax Rebate.

1 80. If Arizona’s elected officials had known that the IRS was going to make
2 an unlawful determination that contradicted its guidance from a few months earlier and
3 was contrary to law, the State could have pursued alternate policies that would not have
4 resulted in the Unlawfully Taxed Amount being siphoned from Arizona, to the
5 detriment of the State and its taxpayers.
6

7 81. The IRS’s unlawful determination is so arbitrary, capricious, and
8 inequitable as to constitute an unlawful targeting of Arizona and its taxpayers in a
9 manner that deprives Arizona of its right to make informed budgetary decisions in the
10 best interests of the State and its taxpayers.
11

12 82. The IRS has a duty to administer and enforce the tax laws in a lawful
13 manner.
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15 83. The IRS has a duty to administer and enforce the tax laws in a consistent
16 manner.
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18 84. The IRS has a duty to administer and enforce the tax laws in an equitable
19 manner.
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21 85. The IRS has a duty to administer and enforce the tax laws with integrity
22 and fairness to all taxpayers.
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24 86. The IRS understands that taxpayers will rely on its published rulings and
25 guidance.
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27 87. The IRS expects that taxpayers will rely on its published rulings and
28 guidance.
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RESPECTFULLY SUBMITTED this 21st day of February, 2024.

**KRISTIN K. MAYES
ATTORNEY GENERAL**

By: /s/ Clinton N. Garrett

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