Maryland Income Tax
ADMINISTRATIVE RELEASE

Administrative Release No. 40

Subject: Claim of Right

I. General

This release explains the treatment for Maryland income tax purposes when, in the current tax year, a taxpayer repays an amount reported as income on a prior year tax return under a claim of right. Income reported under a claim of right means income that was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to that income. It is then determined in a later year that the taxpayer actually had no right to that income and is required to repay that amount. An adjustment is made on the tax return for the year in which the repayment is made. No amendment is made to the tax return for the year in which the income was reported. Examples of income to which it may appear that a taxpayer has an unrestricted right include, but are not limited to: incorrectly computed wages, bonuses, or unemployment compensation; mistaken distribution of estate proceeds; and erroneous partnership or trust distributions.

II. The Federal Law

Maryland follows the federal law governing tax treatment of repayments under a claim of right, which is codified in Internal Revenue Code (I.R.C.) §1341. I.R.C. §1341 specifies a method of determining whether the adjustment to the tax return for the year of the repayment must be made as a deduction or as a credit. Except as provided in §IIIA of this release, the determination must be made because the benefit to the taxpayer of claiming the repayment amount as a deduction may be less than the tax paid on the repayment amount in the year it was received. In that case, I.R.C. §1341 specifies a method of computing a tax credit for the year of repayment, in order to give the taxpayer the full benefit for the tax paid in the year of receipt.

I.R.C. §1341 also makes it clear that the deduction or credit can be taken only if it appeared that the taxpayer had an unrestricted right to the income and the repayment is made because the taxpayer did not actually have an unrestricted right to the income in the prior year. If the taxpayer did in fact have an unrestricted right to the income in the prior year and the obligation to repay arose as a result of subsequent events, no deduction or credit is allowed under I.R.C. §1341.

III. Computation of deduction or credit for federal purposes

A. Repayment amount is $3,000 or less

If the amount of the repayment is $3,000 or less, the repayment is deducted from income in the year it is repaid.

B. Repayment amount is greater than $3,000

If the amount of the repayment is greater than $3,000, a three step computation is required to determine whether the adjustment to the federal tax return for the year of the repayment must be made as a deduction or as a credit.

Step 1. Determine the federal tax liability for the year of repayment treating the repayment amount as a deduction.

Step 2. Obtain the federal tax liability reported on the federal tax return for the year in which the income was originally received and reported. From that figure, subtract the amount of tax that would have been owed that year if the repaid income had never been received, which is calculated by redoing that year's federal tax return without including the repaid amount in income. The difference is the tax paid on the repayment amount in the year it was received.

Step 3. Determine the federal tax liability for the year of repayment if no deduction or credit is taken for the repayment amount. From that figure, subtract the figure computed in Step 2 for the tax paid on the repayment amount in the year it was received. The difference is the federal tax liability

for the year of repayment using a tax credit to adjust for the repayment.

If the tax computed using a deduction in Step 1 is less than or equal to the tax computed using a credit in Step 3, the adjustment to the federal tax return for the year of repayment must be taken as a deduction. The amount of the repayment is reported as a deduction on the federal tax return for the year it is repaid.

If the tax computed in Step 1 is greater than the tax computed in Step 3, the adjustment to the federal tax return for the year of repayment must be taken as a credit. The amount of the credit is the figure computed in Step 2, the tax paid on the repayment amount in the year it was received.

Example: A taxpayer received unemployment compensation in 2000, without knowledge that he received an overpayment of $5,000 due to an error in the computation of the amount to which he was entitled. In 2002, the taxpayer was notified of the overpayment and was required to repay the $5,000. In both 2000 and 2002, the taxpayers' filing status was married filing joint and the taxpayers are residents of Anne Arundel County. Their 2000 federal income tax return reported taxable income of $55,200 and tax liability of $9,763. Their 2002 federal taxable income before any adjustment for the repayment was $47,670.

The amount of the repayment is more than $3,000, so the taxpayers must use the three step computation to determine the adjustment to make on their 2002 federal income tax return.

Step 1. If the $5,000 is treated as a deduction, their federal taxable income would be reduced to $42,670 and their 2002 federal tax liability would be $5,801.

Step 2. The 2000 federal return reported a tax liability of $9,763 based on taxable income of $55,200. If the $5,000 had never been received, the taxable income would have been $50,200 and the tax liability would have been $8,363. Subtracting $8,363 from $9,763 equals $1,400, which is the amount of tax paid on the $5,000.

Step 3. Without any adjustment for the repayment, the 2002 federal taxable income would be $47,670 and the federal tax liability would be $6,668. Subtracting the $1,400 computed in Step 2 from the $6,668 results in a difference of $5,268. This $5,268 figure is compared to the $5,801 figure from Step 1 to determine whether the adjustment to the 2002 federal return must be taken as a deduction or as a credit.

The adjustment to the 2002 federal return must be taken as a credit because $5,801 is greater than $5,268. With the credit, the taxpayers' 2002 federal tax liability is $5,268.

IV. Maryland law

The taxpayer is entitled to a corresponding Maryland benefit for repaying the income, whether the federal law requires the taxpayer to take a deduction or a tax credit. Federal law considers the adjustment to be a deduction, regardless of which form it actually takes, and Maryland law generally allows federal deductions.

The required documentation, which should be included with the Maryland income tax return filed for the year the repayment is made, is a copy of the document which states that the taxpayer must make the repayment, and a copy of the document which provides evidence that the repayment was actually made.

A. Repayment amount is $3,000 or less

If the repayment amount is $3,000 or less, and reported as an itemized deduction on the federal tax return for the year it is repaid, the deduction will simply flow through to the Maryland return if itemized deductions are reported on the Maryland return. If the taxpayer elects not to claim itemized deductions on the federal or Maryland return, then the taxpayer cannot claim the deduction, or a credit in lieu of the deduction, on the Maryland return.

If the repayment amount is $3,000 or less and the repayment is deducted as a business expense, or as a capital loss, on the federal return for the year it is repaid, the deduction will simply flow through to the Maryland return.

B. Repayment amount is greater than $3,000

If the repayment amount is greater than $3,000 and the adjustment must be made as a deduction on the federal tax return in the year it is repaid, the treatment of the deduction on the Maryland return is the same as the treatment of a deduction for a

repayment amount of less than $3,000 described in § IVA of this release.

If the repayment amount is greater than $3,000 and the adjustment must be made as a credit on the federal tax return for the year it is repaid, the adjustment must also be made as a credit on the Maryland return for that year. The amount of the Maryland credit is calculated as follows:

(1) Obtain the total Maryland tax liability reported on the Maryland tax return for the year in which the repaid income was originally received and reported.

(2) From that figure, subtract the amount of tax that would have been owed that year if the repaid income had never been received, which is calculated by redoing that year's Maryland tax return without including the repaid amount in income.

(3) The difference is the amount of tax paid on the repayment amount in the year it was received. That amount of tax paid is the amount of the Maryland credit to report on the Maryland return for the year in which the repayment is made.

The credit is reported on Maryland Form 502CR, Part H, Line 4 for the year in which the repayment is made. For tax years 2002 through 2004, the credit would be reported on Line 3 of Part J of Maryland Form 502CR. For tax years 1999 through 2001, the credit would be reported on Line 43 of Maryland Form 502, and for prior years on Line 47, with the written notation "Claim of Right IRC 1341." If the amount of the credit is greater than the total Maryland state and local income tax for the year of repayment, the excess is refundable.

Example: The taxpayers described in the Example in § IIIB of this release had 2002 Maryland taxable income of $55,950 including the amount of the repayment. Their 2000 Maryland income tax return reported taxable income of $56,670 and total tax liability of $4,110. If the $5,000 repayment amount had never been received, the 2000 taxable income would have been $51,670 and the total tax liability would have been $3,743. Subtracting $3,743 from $4,110 equals $367, which is the amount the taxpayers report as a credit on their 2002 Maryland tax return. Without the credit, their total 2002 Maryland tax liability would be $4,038. With the credit, the taxpayers' total 2002 Maryland tax liability is reduced to $3,671.

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