Department of Finance and Administration

Legislative Impact Statement

Bill: HB1866
Bill Subtitle: TO ADOPT CURRENT INTERNAL REVENUE CODE PROVISIONS CONCERNING THE COMPUTATION OF INCOME TAX WHEN A TAXPAYER RESTORES AN AMOUNT HELD UNDER A CLAIM OF RIGHT.

Basic Change :

Representative Kerr

The bill adopts Internal Revenue Code Section 1341, otherwise known as the Claim of Right Doctrine. Arkansas requires a taxpayer to report and pay tax on unrestricted income in the year the income is received. If the unrestricted income must be repaid in a future year, the taxpayer will be allowed to claim a deduction in the tax year the repayment is made, even if the unrestricted income was reported in a year that is out of statute. If the repayment calculation results in a decrease in tax that exceeds the tax imposed on the current tax year, the repayment may be treated as a refundable credit. Effective for tax years beginning on or after January 1, 2013.

Revenue Impact :

FY2014 - $100,000 Loss

FY2015 - $125,000 Loss

Taxpayer Impact :

Taxpayers may be entitled to a deduction or a refundable credit on their current year tax return if they reported income on a prior year tax return and it is later determined that the taxpayer is required to repay the income.

Resources Required :

Computer programming changes, booklet changes, return processing changes

Time Required :

Adequate time is provided.

Procedural Changes :

Tax forms and instructions will need to be modified. Return processing will need to be modified. Tax community will need to be informed of the change. Employees will need to be trained to examine and process returns claiming the deduction.

Other Comments :

1. There is language in IRC 1341 that refers to IRC 172, Net Operating losses and IRC 1212, Capital Loss Carrybacks and Carryovers. Arkansas treats these items differently than federal therefore adoption of IRC1341 as is would create a conflict.
2. IRC 1341 allows a refundable credit in certain circumstances.
3. IRC 1341 has been abused by tax protesters who use the claim of right doctrine to incorrectly claim their income is not subject to tax.

Legal Analysis :

HB1866 amends Arkansas Code Title 26, Chapter 51, Subchapter 4 to add an additional section adopting the provisions of 26 U.S.C. §1341, which codifies the claim of right doctrine, as it existed on January 1, 2013.

According to the claim of right doctrine, taxpayers as a general rule must report a receipt that purports to be an income item for the period in which they have control over the income item. If such an item must later be returned (generally, taxpayer no longer has a right to the income), a taxpayer generally will be entitled to take a deduction for the applicable amount in the tax year of the return. Under this

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approach, a taxpayer will generally experience a net negative financial consequence when the taxpayer's marginal tax rate applicable for the tax period in which the item was included in income exceeds the marginal rate for the period in which it is returned. In response to this, Congress enacted the provisions of 26 U.S.C. §1341, which provides that where: (1) an item is included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and (3) the amount of such deduction exceeds $3,000.00, then the tax imposed by this chapter for the taxable year shall be the lesser of the tax for the taxable year computed with such deduction or an amount equal to the tax for the taxable year computed without such deduction, minus the decrease in tax under this chapter (or corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item from gross income for such prior taxable year.

The provisions of 26 U.S.C. §1341 do not limit the amount of time that can pass between the time the item is included in gross income and the time it is later determined that the taxpayer did not have an unrestricted right to the item, which would essentially authorize a credit or refund years after a statute of limitations has expired.

The effective date will be for tax years beginning on or after January 1, 2013.