

810-3-15-20 Federal Income Tax Deduction - Individuals.

(1) **DEFINITIONS.** For the purpose of this regulation, the following words, phrases and abbreviations have these meanings:

(a) **FIT:** Federal income tax. **Depending on the method used for computing FIT (cash basis or accrual method), deductible** ~~Deductible~~ federal income tax **may** includes:

1. Federal income tax withheld by employers during the taxable year.
2. Excess social security or Medicare tax (FICA) and railroad retirement tax (RRTA) withheld during the taxable year and claimed as federal income tax on the federal return for the same year. Regular FICA and RRTA tax withheld cannot be claimed as federal income tax since these can only be claimed as itemized deductions.
3. All federal income tax payments made during the year for liabilities of prior years, including the previous year's payment made when the previous year return was filed.
4. All federal income tax estimate payments made during the year. Any overpayments of previous years which are applied to the current year's estimated tax are not deductible unless the overpayment is included in income as a refund of federal income tax.
5. Earned income credit of the previous year which was applied to the previous year's federal income tax liability.
6. Alternative Minimum Tax.

(b) Federal income tax does not include:

1. Federal accumulated earnings tax,
2. Self-employment taxes,
3. Social security and Medicare tax on tip income not reported to employers,
4. Tax on excess contributions to Individual Retirement Arrangements,
5. Tax (10% Additional Tax) on early distributions from a qualified retirement plan (including IRAs),
6. Tax on excess accumulations in qualified retirement plans (including IRAs),

7. Tax on excess distributions from qualified retirement plans (including IRAs),
8. Advance earned income credit payments,
9. Household employment taxes,
10. Penalties and interest.

(c) **FIT Paid**: Payment includes FIT withholdings, FIT paid by the taxpayer, and FIT paid through wage garnishments.

(d) **FIT Accrued**: Imposed FIT payable for the year.

1. The imposed FIT payable for the year is the net federal income tax liability as shown due on the federal income tax return.

2. The net federal income tax which can be deducted on the Alabama income tax return is the "Tax" amount shown on the federal income tax return as computed on federal taxable income, less all credits which reduce the amount of the taxpayer's federal income tax liability and all credits which are shown as "Payments" on the federal income tax return. In no case will the amount be reduced below zero.

(i) Examples of credits which reduce the federal income tax liability include, but are not limited to: Earned income credit (EIC); Education credits; Credit for child and dependent care expenses; Child tax credit; First-time homebuyer credit; Recovery rebate credit; etc.

(ii) Amounts shown on the federal income tax return as "Payments" which are not credits and which do not reduce the federal income tax liability include, but are not limited to: Estimated tax payments; Federal income tax withheld from Forms W-2 and 1099; Amount paid with request for extension to file; etc.

(e) **Paid or Accrued**: Either paid or accrued, but not both.

(f) **Transition Year**: The year in which the method of computing the FIT deduction is changed; i.e., from cash method to accrual method or vice versa. The change in method can be the result of taxpayer's request or a Revenue Department directive.

(g) **To Contest**: To challenge via some objective act of protest, substantiated by some affirmative evidence of denial of liability by the taxpayer.

(2) (a) **FEDERAL INCOME TAX DEDUCTION FOR RESIDENTS.**— : Net federal income tax may be deducted for the taxable year in which paid or accrued. Taxes are deductible only by the person or entity upon whom they are imposed. A cash basis taxpayer may allocate his federal income tax deduction on the cash basis or accrual basis. Once a method is selected, it shall be consistently applied from year to year, unless approval for a change is obtained from the Department. An accrual basis taxpayer must allocate his federal income tax deduction using the accrual basis.

(b) **FEDERAL INCOME TAX DEDUCTION FOR NONRESIDENTS: The FIT deduction for Alabama shall be apportioned according to the ratio of adjusted gross income from Alabama sources to the total adjusted gross income from all sources (as computed under Alabama law, not federal law). Each annual FIT deduction must be computed separately. Cash basis nonresidents may compute the FIT deduction on the cash basis or may elect to compute it on the accrual basis. The election, once made, must be consistently applied from year to year unless prior written approval for a change is obtained from the Department.**

(3) CHANGE IN METHOD USED TO COMPUTE/ALLOCATE FIT DEDUCTION:

(a) Any other change in methods must be effective with the first day of a tax year.

(b) Any tax year in which a change of methods occurs is a transition year.

(c) There are two ways the method can be changed:

1. Taxpayer request.

(i) Taxpayer's request must be in writing and must include the reason(s) for requesting the change.

(ii) The taxpayer will receive written approval if the request is granted.

(iii) A copy of the written request for a change in method and the Department's written approval must be submitted with the return.

(iv) Once a change in computation and/or allocation methods is approved, it must be consistently applied from the year of change forward.

2. Change in method required by the Department of Revenue.

(i) Effective with any tax year beginning after December 31, 1998, the Department may select the method (cash or accrual basis) used to compute the federal income tax deduction on resident and non-resident returns. Taxpayers

filing a return for a year in which the Department changes the method will be considered to have been granted approval to change methods.

(ii) The method selected by the Department for use is the accrual basis.

(a) FOR RESIDENTS SELECTING THE CASH BASIS:

1. FIT is deducted in the year paid, regardless of the year for which it is imposed.

2. If the taxpayer received a prior-year tax benefit from the deduction of FIT resulting in a reduction of tax paid to Alabama in the prior year, the amount of the FIT refund must be included in income in the year received. See Reg. 810-3-14-.04.

3. EXAMPLE 1: Taxpayer has \$1,200 withheld from his earnings during 19X8 for federal income taxes. In March, 19X8, he paid \$100 additional tax on his 19X7 liability and \$200 on his declaration of estimated tax for 19X8. He paid an additional assessment of \$300 on his 19X5 income in September 19X8, thereby settling a disputed liability for 19X5. The taxpayer reports his income for state income tax purposes using the cash receipts and disbursements method. He may deduct for the calendar year 19X8 all payments listed above, totaling \$1,800.

4. EXAMPLE 2: A taxpayer made the same payments as listed in the preceding example, except that he received a \$300 refund of 19X5 taxes, for which he received a tax benefit, in September, 19X8, thereby settling the disputed 19X5 liability. Taxpayer selected the cash basis to compute the federal income tax deduction. He may deduct for the calendar year 19X8 all payments listed above, totaling \$1,500, and the \$300 refund must be reported as income.

(4) TRANSITION YEAR RULES:

(a) Year of change from cash basis to accrual basis: Any FIT refund received must be reported as income and additional FIT paid must be deducted.

(b) Year of change from accrual basis to cash basis: Any FIT refund received during the transition year for previous tax years shall not be reported as income. Any additional tax paid during the transition year for previous tax years may not be deducted.

(c) After a change from cash to accrual method in non-transition years, refunds of previously deducted accrued taxes must be reported as income and payments of taxes for an accrual basis year, not previously deducted, may be deducted.

(b) (5) FOR RESIDENTS AND NONRESIDENTS USING SELECTING THE ACCRUAL METHOD:

1. Uncontested FIT is deducted in the year for which it is imposed.
2. Contested FIT is deducted in the year in which the liability becomes fixed and certain, but in no case later than the year in which the tax was actually paid. **"Contested FIT" may include FIT amounts subject to change under an amendment to or an audit of the taxpayer's federal income tax return.**

3. Refunded FIT is reported in the year received but only if the taxpayer received a prior-year tax benefit from deduction of the FIT refunded.

4. **EXAMPLE 3 1:** A taxpayer using the accrual basis, ~~who had made the same payments listed in Example 1 above,~~ **had \$1,200 withheld from his earnings during 20X8 for federal income taxes. In March, 20X8, he paid \$100 additional tax on his 20X7 liability and \$200 on his declaration of estimated tax for 20X8. He paid an additional assessment of \$300 on his 20X5 income in September 20X8, thereby settling a disputed liability for 20X5. The taxpayer** determined early in ~~19X9 20X9~~ that his federal income tax liability for ~~19X8 20X8~~ would be \$1,700. He had previously paid \$1,400 and, therefore, would have to pay an additional \$300. He may deduct \$1,700 accrued for ~~19X8 20X8~~ plus \$300 accrued during ~~19X8 20X8~~ on his contested ~~19X5 20X5~~ liability, for a total of \$2,000. He may not deduct \$100 paid in ~~19X8 20X8~~ on his ~~19X7 20X7~~ liability, since this amount accrued in ~~19X7 20X7~~ and should have been deducted in that year.

5. **EXAMPLE 4 2:** **Using the same facts as in the above example, a** taxpayer using the accrual basis, ~~who had made the same payments as those listed in Example 2 above,~~ **made the same payments as listed above, except that he received a \$300 refund of 20X5 taxes, for which he received a tax benefit, in September, 20X8, thereby settling the disputed 20X5 liability. The taxpayer** determined early in ~~19X9 20X9~~ that his federal income tax liability for ~~19X8 20X8~~ would be \$1,700 and that he had paid \$1,400 and would have to pay an additional \$300. He may deduct the \$1,700 accrued for ~~19X8 20X8~~. He may not deduct the \$100 paid in ~~19X8 20X8~~ on his ~~19X7 20X7~~ liability, since this amount accrued in ~~19X7 20X7~~ and should have been deducted in that year. The \$300 refund accrued during ~~19X8 20X8~~ on his contested ~~19X5 20X5~~ tax liability should be reported as income on his ~~19X8 20X8~~ return.

6. **EXAMPLE 3:** **A nonresident taxpayer had adjusted gross income in 20X9 from sources within Alabama of \$10,000 and adjusted gross income from sources within and without Alabama of \$25,000. Data regarding his federal income tax is:**

<u>Federal income tax liability for 20X9</u>	<u>\$5,500</u>
<u>Withheld in 20X9</u>	<u>\$3,600</u>

Paid in 20X9 on 20X9 federal estimate	\$ 800
20X8 federal tax paid in 20X9 (on estimate, final return, or otherwise)	\$ 300

For the 20X9 tax year, the ratio of adjusted gross income from sources within Alabama to adjusted gross income from sources within and without Alabama is 40% (\$10,000 divided by \$25,000). Assuming the taxpayer had consistently used the accrual method, the FIT deduction for 20X9 would be \$2,200.00 (\$5,500.00 x 40%). He may not deduct the \$300 paid in 20X9 on his 20X8 liability, since this amount accrued in 20X8 and should have been deducted in that year.

(c) (6) MARRIED TAXPAYERS: For spouses who file a joint federal income tax return but separate Alabama income tax returns for the same year, the FIT deduction of each is based on the ratio of **Alabama federal** adjusted gross income of each to the total **Alabama federal** adjusted gross income of both.

1. **EXAMPLE 5 4:** Proration Based on Alabama Adjusted Gross Income

	Husband	Wife	Total
Income - Salaries, wages, etc.	\$7,000	\$4,000	\$11,000
Income - Other	500	500	1,000
Totals	\$7,500	\$4,500	\$12,000
Ratio of income for each spouse	62.5%	37.5%	100%
Total federal income tax			\$ 2,400
Husband: \$2,400 x 62.5%	\$1,500		
Wife: \$2,400 x 37.5%		\$ 900	

The husband deducts \$1,500 on his state return and the wife deducts \$900 on her state return for federal income tax. Total federal income tax deducted on both state returns is \$2,400, the amount to be prorated.

~~(3) **NONRESIDENTS:** The FIT deduction for Alabama shall be apportioned according to the ratio of adjusted gross income from Alabama sources to the total adjusted gross income from all sources (as computed under Alabama law, not federal law). Each annual FIT deduction must be computed separately. Cash basis nonresidents may compute the FIT deduction on the cash basis or may elect to compute it on the accrual basis. The election, once made, must be consistently applied from year to year unless prior written approval for a change is obtained from the Department.~~

~~(a) **FOR NONRESIDENTS SELECTING THE CASH BASIS:**~~

~~1. FIT is deducted in the year paid, regardless of the year for which it is imposed.~~

~~2. Refunded FIT is reported in the year received but only if the taxpayer received a prior-year tax benefit from deduction of the FIT refunded.~~

~~3. Copies of the federal income tax returns for all years used in the computation of the FIT deduction must be submitted with the return.~~

~~4. EXAMPLE 6: A nonresident taxpayer had adjusted gross income in 19X2 from sources within Alabama of \$10,000 and adjusted gross income from sources within and without Alabama of \$25,000. Data regarding his federal income tax is:~~

Federal income tax liability for 19X2	\$5,500
Withheld in 19X2	\$3,600
Paid in 19X2 on 19X2 federal estimate	\$ 800
19X1 federal tax paid in 19X2 (on estimate, final return, or otherwise)	\$ 300
19X0 federal tax paid in 19X2	\$ 500
19X1 federal income tax refund received in 19X2	\$ 400
19X1 ratio of Alabama AGI to federal AGI	60%
19X0 ratio of Alabama AGI to federal AGI	30%
(19X1 and 19X0 ratios based on 19X1 and 19X0 returns.)	

~~For the 19X2 tax year, the ratio of adjusted gross income from sources within Alabama to adjusted gross income from sources within and without Alabama is 40% (\$10,000 divided by \$25,000).~~

Total 19X2 payment	\$4,400
Deduction for 19X2 tax (40% of \$4,400)	\$1,760
Deduction for 19X1 tax (60% of \$300)	\$ 180
Deduction for 19X0 tax (30% of \$500)	\$ 150
Refund of 19X1 tax (60% of \$400)	\$
240	
Total 19X2 FIT deduction (\$1,760 + \$180 + \$150 - \$240)	\$1,850

~~(b) FOR NONRESIDENTS SELECTING THE ACCRUAL BASIS:~~

~~1. Uncontested FIT is deducted in the year for which it is imposed.~~

~~2. Contested FIT is deducted in the year in which the liability becomes fixed and certain, but in no case later than the year in which the tax was actually paid.~~

~~3. Refunded FIT is reported in the year received but only if the taxpayer received a prior-year tax benefit from deduction of the FIT refunded.~~

~~4. EXAMPLE 7: Using the information in Example 6 and assuming the taxpayer had consistently used the accrual method, the FIT deduction for 19X2 would be \$2,200.00 (\$5,500.00 x 40%).~~

~~(4) CHANGE IN METHOD USED TO COMPUTE/ALLOCATE FIT DEDUCTION:~~

~~(a) Any change in methods must be effective with the first day of a tax year.~~

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~~(c) There are two ways the method can be changed:~~

~~1. Taxpayer request.~~

~~(i) Taxpayer's request must be in writing and must include the reason(s) for requesting the change.~~

~~(ii) The taxpayer will receive written approval if the request is granted.~~

~~(iii) A copy of the written request for a change in method and the Department's written approval must be submitted with the return.~~

~~(iv) Once a change in computation and/or allocation methods is approved, it must be consistently applied from the year of change forward.~~

~~2. Change in method required by the Department of Revenue.~~

~~(i) Effective with any tax year beginning after December 31, 1998, the Department may select the method (cash or accrual basis) used to compute the federal income tax deduction on resident and non-resident returns. Taxpayers filing a return for a year in which the Department changes the method will be considered to have been granted approval to change methods.~~

~~(5) TRANSITION YEAR RULES:~~

~~(a) Year of change from cash basis to accrual basis: Any FIT refund received must be reported as income and additional FIT paid must be deducted.~~

~~(b) Year of change from accrual basis to cash basis: Any FIT refund received during the transition year for previous tax years shall not be reported as income. Any additional tax paid during the transition year for previous tax years may not be deducted.~~

~~(c) After a change from cash to accrual method in non-transition years, refunds of previously deducted accrued taxes must be reported as income and payments of taxes for an accrual basis year, not previously deducted, may be deducted.~~

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