BEST TAX PRACTICE -

Why Is My State Tax Refund Taxable?

"Aren't I being taxed twice on that money?"

Federal tax returns are always completed first; before any state tax returns.

When completing the federal return, one is allowed to deduct on their federal tax return 100% of their state taxes paid (withheld) as reported on their W2 as well as any other state taxes paid toward their state income tax liability. On the federal return, the state income tax deduction is taken on Schedule A.

Then, when the state return is completed, should the state issue a refund, the amount of this refund is considered income on your federal return in the year that the state issued the refund.

The difference between the 100% you deducted on your federal return and what you only needed to pay the state (creating the state refund) is now income to be reported on your federal return in the year you receive your state refund.

"What?!? Wait. Didn't I already pay taxes on that money once? They're taxing me again!!!"

EXAMPLE:

- Your W2 showed that you had state taxes withheld in the amount of $100
- When you did your federal return you were able to deduct that $100 on your federal return
- Then, when you did your state tax return, you ended up having a state tax liability of $81 but you had paid in (had withheld) $100
- The state issued you a refund of $19 ($100 - $81 = $19)
- You never declared that $19 on your federal return because it was included in the $100 you deducted on your federal return
- You owe federal taxes on that $19
- You declare that $19 on your federal tax return in the year which the state issued the refund (usually the next year, if you are filing your tax returns on time)

"No, you did not pay any federal taxes on that money."

"Yet."