COA Opinion: Federal tax benefit rule applies under Michigan law

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In *Sturrus v. Department of Treasury*, No. 295403, the Michigan Court of Appeals held that Michigan's Income Tax Act (ITA) incorporates the federal tax benefit rule, 26 U.S.C. 111(a), but the rule did not apply to the plaintiff's tax return.

After collecting interest on loans made to Pulper Distributing Company ("Pulper"), the plaintiffs discovered that Pulper was a Ponzi scheme. The plaintiffs claimed a "below the line" theft-loss deduction, which they took after determining the adjusted gross income. The plaintiff's claimed deduction had no effect on their Michigan income tax liability, because Michigan law does not recognize such a deduction. Pulper subsequently entered into bankruptcy and the trustee demanded repayment of the interest that was previously paid to the plaintiffs. The plaintiffs offset the repayment of interest against their lost investments in Pulper and reported an "above the line" theft-loss recovery, which was included in the calculation of adjusted gross income. To avoid double taxation, the plaintiffs deducted the amount of their theft-loss recovery from their adjusted gross income and claimed a tax refund. The Department audited the tax return, denied the refund claim, and found a deficiency. The Court of Claims held that ambiguity in Michigan tax law allowed for recognition of the tax benefit rule and granted summary judgment for the plaintiffs.

The Court of Appeals indicated that the ITA expressly incorporates federal principles in calculating taxable income and therefore taxable income in Michigan must be calculated using the definitions in the International Revenue Code (IRC). The tax benefit rule, which permits a taxpayer "to exclude from gross income any income that is recovered and was previously deducted in a prior taxable year so long as that previous deduction did not reduce the taxpayer's tax liability," is used to calculate a taxpayer's federal adjusted gross income and therefore also applies to Michigan taxable income calculations. However, because the plaintiffs did not deduct their lost investment on a prior Michigan tax return, they were not entitled to deduct their theft-loss recovery from their Michigan tax return. The Court reversed the Court of Claims, recognizing that the plaintiffs would receive no tax benefit for their losses, but contending that the problem should be rectified in the Legislature rather than the Court.