Navigating the Tax Treatment of Tariff Refunds

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In early 2025, President Trump imposed tariffs through executive orders by declaring national emergencies under the International Emergency Economic Powers Act. By April 2025, the policy evolved into a broad framework that applied a baseline 10 percent tariff on most imports, with higher country-specific rates on major trading partners. In some cases, these tariffs reached 50 percent or more.

On February 24, 2026, the Supreme Court, under the International Emergency Economic Powers Act ruled, by a 6-3 decision, that these measures constituted an unconstitutional use of executive authority. As a result, the tariffs were terminated. The ruling ended the initial phase of broad, universal duties, although litigation continues with respect to subsequent trade actions.

Following the Supreme Court's decision, the refund process initially progressed, with substantial amounts already submitted and partially distributed. However, the administration has indicated that it intends to appeal the court ruling that would make refunds broadly available to all affected importers, rather than limiting relief to those that filed claims. In doing so, the government has taken the position that refunds may require importer-specific determinations, raising questions about whether all taxpayers will be able to access refunds through the administrative process alone. As a result, uncertainty remains as to whether some businesses may need to pursue litigation to obtain full recovery of tariff payments. Nevertheless, many businesses have already received tariff refunds. This raises important questions regarding the tax treatment of these refunds.

Tariff refunds generally follow the same rules as other recoveries and are taxable in the year received. Under Section 111 of the Internal Revenue Code, commonly referred to as the tax benefit rule, if the tariff payments produced a tax benefit in prior years, the refund is included in taxable income in the current year to the extent of the benefit previously obtained. Conversely, if the prior deductions did not reduce federal tax liability for any reason, the refund is not included in income under Section 111.

When tariff costs are capitalized into inventory under Section 263A, the analysis becomes more nuanced. For inventory that remains on hand at year-end, there is no current income inclusion because the tax benefit has not yet been realized. Instead, the tax basis of the inventory must be reduced. When that inventory is subsequently sold, the benefit of the refund is recognized through a reduction in cost of goods sold.

If the tariff costs were capitalized into inventory that was sold in a prior year, the refund is included in income under the tax benefit rule.

In order to determine the proper treatment of these costs, a methodology must be developed to bifurcate tariff costs between amounts attributable to inventory that has already been sold and amounts attributable to inventory that remain on hand. Any methodology used should be reasonable, consistently applied, and appropriately documented.

Additional considerations arise where taxpayers are obligated to share tariff refunds with customers or suppliers. Questions often include whether such payments can offset the refund, how they should be treated for tax purposes, and whether timing differences arise.

Under the accrual method of accounting, a liability is deductible only when the following "all events test" criteria under Section 461(h) are satisfied:

1. All events have occurred to establish the fact of the liability;
2. The amount of the liability can be determined with reasonable accuracy; and
3. Economic performance has occurred.

As a result, amounts paid to customers or suppliers in connection with tariff refunds are generally deductible when economic performance occurs, which for this type of liability is typically when payment is made. Accordingly, if a taxpayer accrues amounts payable but does not make the payments, those amounts generally cannot be used to offset the tariff refund in that year. It should be noted that the refund and the related payments are treated as separate items and cannot be netted solely based on accrual.

This creates the potential for timing differences. As an example, if the refund is recognized in one year but the related payments are made in a subsequent year, the income and corresponding deduction will not align.

A limited exception, commonly referred to as the recurring item exception, may apply in certain circumstances. Under this exception, a taxpayer may deduct certain accrued liabilities in the year the liability is fixed, provided that payment is made within 8.5 months after year-end and all other requirements are satisfied. Careful analysis is required to confirm that the liability is fixed as of year-end and that all criteria for the exception have been met.

In the end, the proper reporting of tariff refunds is less about a single rule and more about applying established principles in a consistent and supportable manner. Taxpayers that approach these issues thoughtfully and maintain clear documentation will be better positioned to support their conclusions.

Prager Metis is ready to assist. Please reach out to your Prager Metis relationship manager to discuss.

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