The Income Tax Treatment of Social Welfare Benefits

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The United States operates a multibillion dollar social welfare system of enormous size and complexity. Millions of Americans receive benefits under such social welfare programs as Social Security, Aid to Families with Dependent Children (AFDC), and food stamps. The federal government alone will spend approximately $650 billion on social welfare programs in fiscal year 1994.

Internal Revenue Service rulings historically have exempted social welfare benefits from income taxation. In the past fifteen years, however, Congress has expressly subjected unemployment compensation and a portion of Social Security benefits to income taxation. This Article considers whether income taxation should be extended to other social welfare benefits. In particular, this Article discusses the appropriateness of taxing AFDC, Supplemental Security Income (SSI), Medicare, Medicaid, food stamps, housing assistance, and workers' compensation.

Part I of this Article describes the major social welfare programs in the United States. Part II outlines the basic structure of the federal income tax and describes how social...
welfare benefits are treated by the income tax system. Finally, Part III surveys some recent proposals to tax particular social welfare benefits and considers the arguments for and against taxing such benefits. The Article concludes that the need for new revenue sources will push the federal government to reconsider the tax treatment of social welfare benefits.

I. OVERVIEW OF THE AMERICAN SOCIAL WELFARE SYSTEM

Dozens of social welfare programs provide assistance to individuals for retirement, disability, health, education, housing, public assistance, employment, and other needs. The vast majority of these social welfare programs transfer cash or in-kind benefits, such as food or medical care, directly to individuals.

Social welfare policy analysts generally differentiate between transfer programs that are “means-tested” and those that are not. Eligibility and benefits for means-tested programs like AFDC, SSI, Medicaid, food stamps, housing assistance, and energy assistance depend upon an individual’s need, as measured by the individual’s income and assets. Eligibility for non-means-tested programs, like Social Security and Medicare, is based on other criteria such as age and work history.

A. Means-Tested Programs

1. Aid to Families with Dependent Children—Aid to Families with Dependent Children (AFDC) provides cash

5. Indeed, some 75 federal programs provide such assistance to low-income individuals. NATIONAL COMM'N FOR EMPLOYMENT POLICY, COORDINATING FEDERAL ASSISTANCE PROGRAMS FOR THE ECONOMICALLY DISADVANTAGED: RECOMMENDATIONS AND BACKGROUND MATERIALS ix, 3 (1991); see also LOW INCOME OPPORTUNITY WORKING GROUP, DOMESTIC POLY COUNCIL, UP FROM DEPENDENCY: A NEW NATIONAL PUBLIC ASSISTANCE STRATEGY 9–15 (1986) (listing 99 low-income assistance programs).

6. Social welfare assistance which is not transferred directly to individuals (such as education grants to schools) and transfers to individuals which are not directly related to social welfare (such as farm subsidies) are beyond the scope of this Article. Similarly, programs providing social welfare assistance to individuals indirectly, such as the exclusion of life insurance proceeds from gross income, I.R.C. § 101(a)(1) (1988), are generally beyond the scope of this Article, as are the various loan and loan guarantee programs, such as the student loan program.

assistance and other services to needy families with dependent children to allow them to become self-sufficient.\textsuperscript{8} AFDC provides cash welfare payments through the states for: (1) needy children who have been deprived of parental support or care due to a parent's incapacitation, death, unemployment or continuous absence from the home; and (2) certain others in the household of a child covered by the program.\textsuperscript{9}

Individual states define the term need, determine benefit levels, establish income and resource eligibility limits within federal guidelines, and administer or supervise the administration of the program in their state. The federal government pays fifty to eighty percent of AFDC costs. AFDC payments vary dramatically from state to state because each state sets different benefit levels. For example, in January 1993, the maximum monthly grant that an AFDC family of three could receive ranged from $120 in Mississippi to $923 in Alaska.\textsuperscript{10}

In fiscal year 1992, the AFDC program had a nationwide, average monthly caseload of almost 4.8 million households, or 13.6 million persons.\textsuperscript{11} The program provided $22.2 billion in total benefits in fiscal year 1992 and cost a total of $2.7 billion to administer.\textsuperscript{12} In fiscal year 1992, monthly AFDC benefits averaged $136 per person and $388 per family.\textsuperscript{13}

2. Supplemental Security Income—Supplemental Security Income (SSI)\textsuperscript{14} is a federal program that provides cash benefits to needy persons who satisfy the program's criteria for age, blindness, or disability.\textsuperscript{15} In 1993, the regular federal benefit was $434 per month for an individual, and $652 per month for a couple.\textsuperscript{16} In 1992, 5.6 million people received over $22.2

\begin{itemize}
  \item \textsuperscript{8} See id. § 601; see also 1993 GREEN BOOK, supra note 2, at 615 (describing the AFDC program and its eligibility requirements).
  \item \textsuperscript{9} 42 U.S.C. § 606(a)-(b) (1988). In addition, many states also provide short-term emergency assistance or general assistance to persons not covered by AFDC. Although the tax treatment of these cash transfer programs follows that of AFDC, the details of these programs are beyond the scope of this Article.
  \item \textsuperscript{10} See 1993 GREEN BOOK, supra note 2, at 655, 657–58.
  \item \textsuperscript{11} Id. at 682.
  \item \textsuperscript{12} Id. at 679.
  \item \textsuperscript{13} Id. at 682.
  \item \textsuperscript{14} 42 U.S.C. §§ 1381–1383d (1988).
  \item \textsuperscript{15} See id. § 1382 (listing SSI eligibility requirements); see also 1993 GREEN BOOK, supra note 2, at 813–17 (describing SSI payments and eligibility requirements).
  \item \textsuperscript{16} 1993 GREEN BOOK, supra note 2, at 823. Some states, however, provide small additional supplements. Id. at 823, 829–30.
\end{itemize}
billion in SSI benefits. In September of 1992, the average monthly benefit paid to an SSI recipient was about $350.

3. Medicaid—Medicaid is a federal-state matching entitlement program which provides medical assistance for needy persons who are aged, blind, disabled, recipients of SSI and AFDC, and pregnant women and children with family incomes below 133 percent of the federal poverty income guidelines. States design and administer their programs within federal guidelines, and the federal government reimburses them for fifty to eighty-three percent of their costs. In fiscal year 1991, the Medicaid program served 28.3 million people at a total cost of $77 billion. The average annual expenditure per person was $2725.

4. Food Assistance—Several social welfare programs provide food assistance to needy households. The largest of these, the Food Stamp Program, is administered by state agencies operating under the supervision of the U.S. Department of Agriculture. The federal government fully finances food stamp benefits and reimburses one-half of a state’s administrative expenses. In general, food stamp benefits are issued in coupon booklets which are used by participating households to buy food items for home preparation and consumption. The amount of benefits is related to the household’s size, its adjusted monthly income, and a maximum monthly benefit level. In fiscal year 1992, the Food Stamp Program served 26.9 million people at a total cost of $24.9 billion. Monthly food stamp benefits averaged $68.50 per person, or about $170 per household.

17. Id. at 815.
18. Id. at 841.
20. See id. § 1396c (listing Medicaid eligibility requirements); see also 1993 GREEN BOOK, supra note 2, at 1633-38 (describing Medicaid program eligibility requirements).
21. See 1993 GREEN BOOK, supra note 2, at 1640.
22. Id. at 1648, 1656.
23. Id. at 1656.
25. See 1993 GREEN BOOK, supra note 2, at 1605-08.
26. See id. at 1607-08.
27. See id. at 1616-19.
28. Id. at 1609.
29. Id. at 1626.
30. Id. at 1617.
The Special Supplemental Food Program for Women, Infants, and Children (WIC) provides food supplements and nutritional education and screening to needy pregnant, breastfeeding, and postpartum women and their infants, as well as to needy children up to age five. This program is federally funded, but it is administered by the states. WIC has categorical income and nutritional risk requirements for eligibility. In fiscal year 1992, the federal government spent $2.6 billion to assist 5.4 million women, infants, and children. In fiscal year 1991, the average monthly cost of a WIC food package was $31.67 per participant.

The National School Lunch Program (NSLP) and the School Breakfast Program provide free and reduced-price meals to needy children at participating elementary and secondary schools. For fiscal year 1992, the federal government spent $5.25 billion on these two programs, with the NSLP alone delivering almost 4.1 billion lunches to an average of 24.5 million students a day.

5. Housing Assistance—A number of programs administered by the U.S. Department of Housing and Urban Development and the U.S. Farmers Home Administration provide housing assistance for low-income households. Most housing assistance is provided in the form of traditional rental or homeowners' assistance. Rental assistance is provided through two basic approaches: (1) project-based aid, like the public housing program and the Section 8 new construction and substantial rehabilitation program, and (2) household-based subsidies, like

32. See id. § 1786(a) (declaring the purpose of WIC); see also 1993 GREEN BOOK, supra note 2, at 1681–83 (describing WIC and its eligibility requirements).
34. 1993 GREEN BOOK, supra note 2, at 1683.
35. Id. at 1681.
37. Id. § 1773.
38. See 1993 GREEN BOOK, supra note 2, at 1677 (noting that in 1992 over 90,000 schools participated in the NSLP and that over 50,000 schools participated in the School Breakfast Program).
39. Id. at 1678–79.
40. Id. at 1677.
Section 8 rental certificates and vouchers. Homeowners' assistance is provided in the form of mortgage-interest subsidies. Federal housing assistance never has been provided as an entitlement to all eligible low-income households. In fiscal year 1993, the federal government spent almost $20 billion to provide housing assistance to 5.7 million households. The average subsidy per participating household was $4240.

6. Energy Assistance—The Low-Income Home Energy Assistance Program (LIHEAP) helps low-income families meet their home energy expenses. In fiscal year 1992, the federal government allotted almost $1.5 billion to the states for distribution to eligible low-income households to pay their heating or cooling bills, for low-cost weatherization, and to assist households during energy-related emergencies. Over 5.8 million households received heating assistance benefits.

B. Non-Means-Tested Programs

1. Social Security—The Old-Age and Survivors Insurance program (OASI) provides a pension to retired workers and their dependents and survivors in the form of monthly cash benefits. The Disability Insurance program (DI) provides similar payments to disabled workers under age sixty-five and their dependents. These programs protect workers who hold employment that is covered by the Social Security system.
employee contribution is withheld from wage and salary payments and is matched by employers. Roughly ninety-six percent of the current paid work force is engaged in covered employment.59

After retirement, disability, or death, monthly Social Security benefits are paid to insured workers and their eligible dependents or survivors. Although benefit calculations are complex, they generally are related to the earning history of the insured worker.60 The programs are quite large and costly. For example, in December 1992, there were 41.5 million beneficiaries in the OASI and DI programs,61 and in fiscal year 1993, the total cost of the programs was estimated to be almost $305 billion.62 The average payment to a retired worker was $653 per month,63 and the average payment to a disabled worker was $626 per month.64 Additional amounts were paid to dependents of these covered workers.65

2. Medicare—Medicare66 is a federal health care program for the aged and for certain disabled persons.67 It consists of two parts: the hospital insurance program (part A) and the supplementary medical insurance program (part B). Persons aged sixty-five and older are entitled to protection under part A if they are “fully insured” under Social Security. Participation in Part B is voluntary and requires the payment of a monthly premium of $36.60 as of January 1, 1993.68 People under age sixty-five who receive monthly Social Security disability benefits are also eligible for Medicare after a two-year waiting period.69

In fiscal year 1993, 31.3 million aged persons and 3.7 million disabled persons were estimated to be covered by Medicare part A, and 30.8 million aged persons and 3.4 million disabled persons elected coverage under part B.70 The total program

59. See id. at 3.
60. See id. at 4.
61. Id. at 123.
62. Id. at 86.
63. Id. at 42.
64. Id. at 52.
65. Id.
68. See 1993 Green Book, supra note 2, at 137.
70. 1993 Green Book, supra note 2, at 137.
costs are projected to reach $167.3 billion in fiscal year 1994. The average annual benefit per person enrolled under Part A is projected to be $2842 in fiscal year 1994, and the average annual benefit per person enrolled under Part B is projected to be $1802.

3. Unemployment Compensation—Unemployment Compensation is a joint program of the federal government and the states which provides cash benefits to recently unemployed individuals. States administer their programs within federal guidelines. Ninety-nine percent of all wage and salary workers and ninety percent of all employed persons are covered by unemployment compensation, totalling about 105 million individuals in all.

Benefits are financed by funds raised under the Federal Unemployment Tax Act (FUTA) taxes, a gross tax of 6.2% on the first $7000 paid annually by covered employers to each employee. States set the benefit amounts as a fraction of the individual’s weekly wage up to some state-determined maximum. Unemployed persons usually receive unemployment benefits for twenty-six weeks; however, the federal-state extended benefits program provides for up to an additional thirteen weeks of coverage. In fiscal year 1992, national weekly benefits averaged $173 with benefits being paid for an average of 15.9 weeks, resulting in average total benefits of $2751.

4. Workers’ Compensation—Workers’ compensation programs provide monetary and medical benefits to workers disabled on the job and to survivors of workers who are killed by work-related accidents or illness. While most workers’ compensation programs are managed and financed by individual states, the federal government provides similar benefits through a number of programs. Approximately 95.1 million workers

71. Id. at 192.
72. Id. at 138–39.
74. See 1993 GREEN BOOK, supra note 2, at 474 (discussing the Unemployment Compensation Program).
75. See id. at 490.
79. 1993 GREEN BOOK, supra note 2, at 501.
80. See id. at 1702.
81. See William J. Nelson, Jr., Workers’ Compensation: 1984–88 Benchmark Revisions, SOC. SECURITY BULL., Fall 1992, at 41 (stating that all 50 states maintain workers’ compensation programs and that the federal government maintains similar
representing 87% of the workforce, were covered by workers' compensation laws during an average month in 1990. Workers' compensation benefits vary dramatically from state to state. For example, in July of 1988, the maximum weekly benefit level ranged from $175 in Georgia to $1094 in Alaska, with a median amount of $340.50. In 1990, total workers' compensation benefit payments exceeded $38 billion.

II. THE FEDERAL INDIVIDUAL INCOME TAX TREATMENT OF SOCIAL WELFARE BENEFITS

A. An Overview of the Federal Income Tax

The federal income tax is imposed on a taxpayer's taxable income. A taxpayer first determines the amount of her gross income. The term "gross income" means all income from whatever source derived, including, but not limited to, wages, salary, tips, dividends, interest, rents, and royalties received by the taxpayer during the taxable year. The Supreme Court has interpreted the term broadly to include all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." At the same time, however, there are numerous statutory exclusions from gross income. For example, most gifts and inheritances received by a taxpayer are excluded expressly from gross income.

To determine her taxable income, a taxpayer subtracts allowed deductions from gross income. Certain deductions are allowed without regard to whether the taxpayer chooses to itemize. After taking these deductions, most taxpayers simply claim a

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programs for the District of Columbia and for federal workers).
82. See 1993 GREEN BOOK, supra note 2, at 1703–05.
83. See id. at 1703.
84. Id. at 1705.
86. Id. § 61.
89. Id. § 102(a).
90. Id. § 63(a).
91. See, e.g., id. § 62 (allowing deductions for certain business expenses and reimbursed expenses of employees).
standard deduction and personal exemptions. Many taxpayers, however, claim certain itemized deductions in lieu of the standard deduction. A taxpayer's tentative tax liability is then determined by applying various marginal tax rates to taxable income. The amount that the taxpayer must pay or, alternatively, will receive as a refund, is the taxpayer's tentative tax liability minus allowable credits.

Of the $1.2 trillion that the federal government expects to raise in fiscal year 1994, $500.8 billion is expected to come from the individual income tax.

B. The Income Tax Treatment of Social Welfare Benefits

By long-standing IRS policy, public assistance payments are excluded from gross income. According to the pertinent IRS publication, a taxpayer should not include as taxable income “benefit payments from a public welfare fund, such as payments due to blindness.” Thus, the value of AFDC, SSI, food stamps,

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92. Id. § 63(b)(1), (c) (granting a standard deduction of $5000 for a joint return and $3000 for an unmarried individual).
93. Id. §§ 63(b)(2), 151 (allowing a $2000 exemption per dependent).
94. Id. §§ 63(d), 161–219. (providing that itemized deductions include medical expenses, charitable gifts, retirement savings, and certain moving expenses).
95. I.R.C. § 1 (1988). In addition, a 10% surtax is imposed on high-income taxpayers. Id.
96. I.R.C. §§ 6401(b), 6402 (1988) (detailing provisions for determining the amount of overpayments and allowing for refunds or credits).
98. See 1993 GREEN BOOK, supra note 2, at 1760.
99. E.g., Rev. Rul. 78-170, 1978-1 C.B. 24 (excluding from gross income payments to reduce energy costs for low-income, elderly, or disabled heads of households); Rev. Rul. 76-395, 1976-2 C.B. 16 (excluding from gross income grants to low-income recipients under the Housing and Community Development Act, 42 U.S.C. §§ 5301–5317 (1988), which are given primarily for the correction of critical code violations); Rev. Rul. 76-144, 1976-1 C.B. 17 (excluding from gross income grants under the Disaster Relief Act, 42 U.S.C. §§ 5121–5202 (1988), to persons who as a result of a major disaster are unable to meet necessary expenses and needs); Rev. Rul. 70-217, 1970-1 C.B. 13, superseding I.T. 3447, 1941-1 C.B. 191 (excluding from gross income grants under § 202 of Title II of the Social Security Act, 42 U.S.C. § 402 (1988), which are given as insurance benefit payments); see also 1993 GREEN BOOK, supra note 2, at 1062 (noting that many types of welfare payments are excludable from gross income pursuant to revenue rulings).
Medicaid, and housing assistance benefits are not subject to income taxation.  

1. Social Security—Originally, the Internal Revenue Code did not address the tax treatment of Social Security benefits, however, a series of IRS rulings have exempted Social Security benefits from income taxation. Over the years, many tax analysts have suggested taxing Social Security benefits more like other forms of retirement benefits or income that is designed to replace wages.

Partial taxation of Social Security benefits was adopted in the Social Security Amendments of 1983. The Amendments added a new § 86 to the Internal Revenue Code which required single taxpayers with incomes over $25,000 and married couples with incomes over $32,000 to pay income taxes on as much as half of their Social Security benefits. Basically, the sum of a taxpayer's adjusted gross income, tax-free interest income, and one-half of Social Security retirement benefits was compared to a base amount of $25,000 for a single taxpayer, or $32,000 for a married couple filing a joint tax return. If the sum exceeded the base amount, the amount of Social Security retirement benefits to be included in taxable income was the

101. The applicable IRS publication also expressly excludes payments from a state fund for victims of crime that are in the nature of welfare payments; payments from a state welfare agency for taking part in a work-training program which do not exceed the public welfare benefits they replace; grants under the Disaster Relief Act, 42 U.S.C. §§ 5121-5202 (1988); mortgage assistance payments; payments made by a state to reduce the cost of winter energy use; and food benefits received. Id.

Social welfare benefits also are not subject to Social Security taxes. Such benefits are not "wages" for Federal Insurance Contributions Act purposes, nor are they "self-employment earnings" for Self-Employment Compensation Act purposes. See I.R.C. §§ 3121, 1402 (1988) (defining the terms wages and self-employment earnings).

Whether any social welfare benefits should be subject to Social Security taxation is beyond the scope of this Article. Nevertheless, it is worth noting that some social welfare benefits, like workers' compensation and unemployment compensation, are substitutes for wages and self-employment earnings that are subject to Social Security taxation.


103. See, e.g., RICHARD GOODE, THE INDIVIDUAL INCOME TAX 103-07 (1976) (suggesting that a fraction of Social Security benefits be taxed); see infra Part III.A.1.


106. See I.R.C. § 86 (1988). This section also applies to tier one railroad retirement benefits. Id. § 86(d).
lesser of: (1) one-half of the excess of such amount over the base amount, or (2) one-half of benefits received.

The Omnibus Budget Reconciliation Act of 1993\textsuperscript{107} added a second tier of Social Security benefit inclusion to the formula for determining the amount of benefits to be taxed. Beginning in 1994, single taxpayers with incomes over $34,000 and married couples with incomes over $44,000 will have to pay income taxes on as much as eighty-five percent of their Social Security benefits.\textsuperscript{108} Eighty-five percent was set as the maximum because no near-retirees would have paid employee Social Security taxes totaling fifteen percent of the present value of their benefits.\textsuperscript{109}

Neither the $25,000 and $32,000 floors nor the $34,000 and $44,000 floors are indexed for inflation, and the Congressional Budget Office has estimated that in 1994 more than 8.1 million beneficiaries will be affected by the taxation of benefits; a figure which may amount to twenty-two percent of all Social Security beneficiaries.\textsuperscript{110} Additionally, the lack of indexing, coupled with inflation, will result in even more taxpayers paying taxes on their Social Security benefits in future years.\textsuperscript{111}

2. Medicare—Medicare benefits never have been expressly excluded from gross income by statute.\textsuperscript{112} In 1970, however, soon after the enactment of Medicare, the IRS ruled that benefits under Medicare are not includable in gross income.\textsuperscript{113} The ruling applies to Medicare benefits received both under Part A (hospital insurance) and Part B (supplementary medical insurance). The IRS excludes Part A benefits from gross income because they "are in the nature of disbursements made in furtherance of the social welfare objectives of the Federal government."\textsuperscript{114} Part B payments are excluded from income

\textsuperscript{108} Id.
\textsuperscript{109} See Robert J. Myers, \textit{Is the 85-Percent Factor for Taxing Social Security Benefits Perpetually Correct?}, 58 TAX NOTES 1545, 1545–46 (1993) (arguing that the 15% factor may be on the low side and that 20% would result in "rough justice" until 1997).
\textsuperscript{110} See 1993 GREEN BOOK, supra note 2, at 32.
\textsuperscript{111} See Myers, supra note 109, at 1545 (noting that the lack of indexing means that the income floors will "wither away," eventually resulting in 40% of beneficiaries paying taxes on their benefits).
\textsuperscript{112} See 1993 GREEN BOOK, supra note 2, at 1048–49.
\textsuperscript{114} Id.
because they fall under a provision which exempts from gross income amounts received through health insurance for personal injuries or sickness. 115

3. Unemployment Compensation—Like other social welfare benefits, unemployment benefits originally were not subject to income taxation. 116 By the 1970s, however, many tax analysts argued that the exclusion of unemployment benefits from taxation was inequitable and also had an adverse impact on the frequency and duration of unemployment. 117 In a relatively unusual triumph of policy analysis over politics, 118 Congress began taxing a portion of unemployment compensation benefits in 1979. 119 In 1984, the U.S. Department of Treasury recommended repealing the partial exclusion that remained. 120 In 1985, President Reagan made that recommendation to Congress, 121 and since 1987, unemployment compensation

115. Id.; see I.R.C. § 104(a) (1988).
116. See generally 1993 GREEN BOOK, supra note 2, at 499-500 (describing the tax treatment of unemployment compensation).
117. See, e.g., U.S. DEP'T OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 56 (1977) [hereinafter BLUEPRINTS] (stating that tax free unemployment compensation creates a disincentive to seeking employment during the benefit eligibility period); Emil M. Sunley, Jr., Employee Benefits and Transfer Payments, in COMPREHENSIVE INCOME TAXATION 100-01 (Joseph A. Pechman ed., 1977) (stating that it is inequitable to exempt unemployment benefits from taxation where individuals have other sources of income, such as a working spouse).

The exclusion of unemployment compensation benefits from gross income was thought to be inequitable because it resulted in persons with equal spending power owing differing amounts of income taxes. Worse still, the value of the exclusion of unemployment compensation benefits increased with the worker's marginal tax rate so that high-income workers received the largest benefit from the exclusion. See BLUEPRINTS, supra, at 56.

The exclusion of unemployment compensation benefits from taxation also was thought to create disincentives for work. In a seminal piece, economist Martin Feldstein showed that, on the average, unemployment benefits replaced more than 60% of lost after-tax income. See Martin I. Feldstein, Unemployment Compensation: Adverse Incentives and Distributional Anomalies, 27 NAT'L TAX J. 231, 242-43 (1974). Feldstein found that such high replacement rates had an adverse impact on the frequency and duration of unemployment. Id. at 232-33. Accordingly, he urged that unemployment compensation benefits be taxed. Id. at 243.

118. Taxing unemployment benefits was considered bad politics because of the persistent myths that such benefits return only a small percentage of lost income and that only the poor collect such benefits. See Feldstein, supra note 117, at 231; Sunley, supra note 117, at 105-06.
121. THE WHITE HOUSE, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS,
benefits have been fully includable in income. The Congressional Budget Office (CBO) estimates that in 1994 more than 8.3 million taxpayers, eighty-seven percent of all unemployment compensation beneficiaries, will be affected by the taxation of unemployment compensation benefits.

4. Workers’ Compensation—The Internal Revenue Code expressly exempts workers’ compensation benefits from taxation. This exclusion has been included in the tax law since 1918, and it appears that workers’ compensation payments were not subject to tax prior to that time.

In general, gross income does not include amounts received under a workers’ compensation act or under a statute in the nature of a workers’ compensation act which provides for compensation to employees for personal injuries or sickness incurred in the course of employment. The exclusion also applies to workers’ compensation payments made to survivors of deceased employees.

On the other hand, the exclusion does not apply to a retirement pension or annuity that is determined on the basis of the employee’s age, length of service, or contribution to the plan, even if the employee’s retirement is the result of a work injury or sickness. Nor does the exclusion apply to amounts received as compensation for a nonoccupational injury or sickness, or as compensation for a work injury to the extent that they exceed amounts available under applicable workers’ compensation acts.

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GROWTH, AND SIMPLICITY 49–56 (1985) [hereinafter REAGAN TAX PROPOSAL].


123. See 1993 GREEN BOOK, supra note 2, at 500.


125. See 1993 GREEN BOOK, supra note 2, at 1073.


128. Id.

129. Id.
III. RECENT PROPOSALS TO TAX SOCIAL WELFARE BENEFITS

A. Forces Pushing the Federal Government to Tax Social Welfare Benefits

In recent years, two forces have pushed the federal government towards further taxation of social welfare benefits. First, most tax reformers favor a broad definition of income that would logically include social welfare benefits in the income tax base. Second, the need for revenues to offset the federal government's perpetual budget deficits has made the ever-growing social welfare system an inviting target for taxation.

1. Defining the Income Tax Base to Include Social Welfare Benefits—Over the years, many proposals for income tax reform have focused on conforming the income tax base to some comprehensive definition of economic income. The basic notion

130. The classic economic definition of income, also known as the Haig-Simons definition of income, is as follows:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The sine qua non of income is gain, as our courts have recognized in their more lucid moments—and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); accord STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., ANALYSIS OF PROPOSALS RELATING TO WIDENING THE BASE AND LOWERING THE RATES OF THE INCOME TAX 3–4 (Comm. Print 1982) ("income is defined as the ability to provide oneself with goods and services, other than those goods and services which are necessary to earn the income. Thus, for this purpose, income is generally measured by subtracting from the sum of the gross receipts and appreciation in asset value of a taxpayer the amounts spent on goods or services which are costs of generating those gross receipts and that appreciation."); Robert M. Haig, The Concept of Income—Economic and Legal Aspects, in THE FEDERAL INCOME TAX 7 (Robert M. Haig ed., 1921); cf. BLUEPRINTS, supra note 117, at 3 ("income may be viewed as the sum of consumption and change in net worth in a given time period. Rather, the measurement of income is accomplished by using the accounting notion that the sum of receipts from all sources within a given time period must equal the sum of all uses."). See generally WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? (Joseph A. Pechman ed., 1980) (reporting on a conference studying a proposal to tax expenditures); Henry Aaron, What Is a Comprehensive Tax Base Anyway?, 22 NAT'L TAX J. 543 (1969) (advancing the discussion of the use of the Haigs-Simons definition of income in a comprehensive tax
behind comprehensive income taxation is that all income, regardless of its source, should be included in the tax base and taxed alike. Proponents of comprehensive income taxation generally believe that the exclusion from income of social welfare benefits represents a deviation from a "pure" income tax which would reach all economic income. Accordingly, at least some proponents of comprehensive income taxation have called for income taxation of virtually all social welfare transfer payments. After all, many social welfare beneficiaries are better off than their neighbors who have the same income but who cannot exclude any portion of their incomes from tax.

On the other hand, some proponents of comprehensive income taxation would stop short of taxing means-tested benefits. These reformers generally argue that equity concerns are satisfied because means-tested benefits by their very nature already are targeted to the most needy, and that taxing in-kind benefits would present too many valuation and administrative difficulties.

Nevertheless, as an outgrowth of the movement for comprehensive income taxation, the Congressional Budget and

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134. See, e.g., GOODE, supra note 103, at 103 (arguing that there is a persuasive case for excluding means-tested government transfer payments from taxable income); David I. Kempler, Transitional Rules as a Tool for Effective Tax Reform, 36 BAYLOR L. REV. 765, 779–81 (1984) (arguing that Social Security benefits should not be taxable); Sunley, supra note 117, at 103–04 (stating that benefits under programs with stringent means tests should not be taxable to beneficiaries).
Impoundment Control Act of 1974 (the Act) requires the federal government to report, through tax expenditure budgets, the revenue lost as a result of deviations from a "pure" income tax. The Act defines tax expenditures as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Thus, the definition of a tax expenditure draws a distinction between the ideal provisions of an income tax and the special or preferential provisions that are exceptions to that ideal structure.

The Act, however, does not specify the ideal structure of a tax law. Consequently, deciding which provisions are special or preferential is necessarily a matter of judgment. Scholars are engaged in an ongoing debate over whether it is useful or proper to flag certain expenditures in this way. Nevertheless, the

138. According to the Joint Committee on Taxation,

the normal structure of the individual income tax includes the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax provisions can be viewed as exceptions to the normal law.


various exclusions of social welfare benefits routinely have been identified as tax expenditures in the tax expenditure budgets prepared annually by the Office of Management and Budget\(^{140}\) and by the Joint Committee on Taxation\(^{141}\) and in reports of the House Ways and Mean Committee,\(^{142}\) the Senate Budget Committee,\(^{143}\) and the CBO.\(^{144}\)

Table 1 reproduces the House Ways and Means Committee's estimates of the revenue losses attributable to the special income tax deductions, exclusions, and credits related to all of the federal government's social welfare policy objectives in fiscal year 1994.\(^{145}\) Table 1 shows that the partial exclusion of Social

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142. See, e.g., 1993 GREEN BOOK, supra note 2, at 1020–89 (identifying Medicare, Social Security benefits, workers' compensation, and special benefits for coal miners as tax expenditures); infra Table 1 and accompanying text.


145. No revenue-loss estimates are available for the basic standard deduction or personal exemption deductions, because the federal government's revenue estimators apparently consider these to be "normal" features of an income tax, not tax expenditures. See, e.g., STAFF OF JOINT COMM. ON TAXATION, supra note 138, at 3 (stating that these deductions are not viewed as expenditures because they approximate the amount of income necessary to obtain minimum amounts of food, shelter, and clothing).


<table>
<thead>
<tr>
<th>ITEM</th>
<th>AMOUNT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax expenditures related to retirement:</td>
<td></td>
</tr>
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<td>Net exclusion of private retirement plan contributions and earnings</td>
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<tr>
<td>Keogh plans</td>
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<td>Individual retirement plans</td>
<td>6.2</td>
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<tr>
<td>Exclusion of Social Security and railroad retirement benefits</td>
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<tr>
<td>Tax expenditures related to health:</td>
<td></td>
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<tr>
<td>Exclusions of employer contributions for medical insurance premiums and medical care</td>
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<tr>
<td>Exclusion of Medicare benefits:</td>
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<tr>
<td>Medicare Part A</td>
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<td>Medicare Part B</td>
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<tr>
<td>Deductibility of medical expenses</td>
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<td>Tax expenditures related to poverty:</td>
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<tr>
<td>Earned income tax credit:</td>
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<tr>
<td>Nonrefundable portion</td>
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<td>Refundable portion</td>
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<tr>
<td>Credit for child medical insurance premiums</td>
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<td>Nonrefundable portion</td>
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<tr>
<td>Refundable portion</td>
<td>.7</td>
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<tr>
<td>Exclusion of public assistance and SSI payments</td>
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<td>Tax expenditures related to employment</td>
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<td>Dependent care credit</td>
<td>2.8</td>
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<tr>
<td>Exclusion of employer-provided dependent care</td>
<td>.5</td>
</tr>
<tr>
<td>Targeted jobs tax credit</td>
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<tr>
<td>Employee stock ownership plans</td>
<td>.8</td>
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<tr>
<td>Exclusion for benefits provided under cafeteria plans</td>
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<td>Tax expenditures related to elderly and disabled:</td>
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<tr>
<td>Exclusion of workers' compensation and special benefits for disabled coal miners:</td>
<td></td>
</tr>
<tr>
<td>Worker's compensation</td>
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<tr>
<td>Special benefits for disabled coal miners</td>
<td>.1</td>
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<tr>
<td>Additional standard deduction for elderly and blind</td>
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</tr>
<tr>
<td>Tax credit for the elderly and disabled</td>
<td>.1</td>
</tr>
<tr>
<td>Tax expenditures related to housing:</td>
<td></td>
</tr>
<tr>
<td>Deductibility of mortgage interest</td>
<td>45.5</td>
</tr>
<tr>
<td>Deductibility of property tax on owner-occupied housing</td>
<td>13.7</td>
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<tr>
<td>Deferral of capital gains on sale of principal residence</td>
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<tr>
<td>Exclusion of capital gains on sale of residence of persons 55 and over</td>
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<tr>
<td>Exclusion of interest on state and local bonds for owner-occupied housing</td>
<td>1.7</td>
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<tr>
<td>Depreciation of rental housing in excess of alternative depreciation system</td>
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<tr>
<td>Exclusion of interest on state and local bonds for rental housing</td>
<td>1.1</td>
</tr>
<tr>
<td>Low-income housing credit</td>
<td>1.5</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>256.4</td>
</tr>
</tbody>
</table>

**SOURCE:** Staff of the House Comm. on Ways and Means, 103d Cong., 1st Sess., Overview of Entitlement Programs: 1993 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means 1022-23 (Comm. Print 1993).
Security benefits was estimated to cost the federal government $28 billion, the exclusion of Medicare benefits was estimated to cost $13.1 billion, the exclusion for public assistance cash payments was estimated to cost $0.5 billion, and the exclusion of workers' compensation was estimated to cost $4.2 billion.\footnote{146}

2. The Need for Revenues and the Social Welfare Benefit Explosion—One of the most important forces behind recent tax legislation is the need for revenues.\footnote{147} Even with the Omnibus Budget Reconciliation Act of 1993,\footnote{148} the national debt exceeds $3 trillion, and annual federal deficits in the neighborhood of $200 billion dollars are expected for years to come.\footnote{149} This need for revenue surely will be an impetus for reconsideration of the tax treatment of social welfare benefits.

The amount of revenues that could be raised by taxing social welfare benefits has increased dramatically in recent years. There are two reasons for this increase in potential revenues. First, the total amount of social welfare benefits transferred to individuals has increased markedly since the IRS first ruled that social welfare payments were excluded from gross income. For example, thirty years ago, food stamps and Medicare did not even exist, and there were far fewer Social Security beneficiaries. In 1993, however, more than 25 million Americans received food stamps,\footnote{150} more than 35 million Americans were covered by Medicare,\footnote{151} and more than 40 million Americans received Social Security benefits.\footnote{152}

Second, the value of personal exemptions has eroded dramatically since World War II, to the point where many relatively low-income workers now must pay income taxes.\footnote{153} The personal exemption amount was $600 in 1948, the

\footnotesize{146. The consolidated revenue loss attributable to all tax expenditures related to retirement, health, poverty, employment, and disability was estimated to be $172.4 billion. \textit{See} 1993 GREEN BOOK, supra note 2, at 1020. Each tax expenditure item is measured without regard to other items. Hence, the addition of tax expenditure items may be misleading. \textit{See} id. at 1020 n.4.


150. 1993 GREEN BOOK, supra note 2, at 1626.

151. \textit{Id.} at 137.

152. \textit{Id.} at 123.

equivalent of about $7000 in 1993.\textsuperscript{154} Yet, the actual personal exemption was just $2350 in 1993.\textsuperscript{155} This erosion in the value of the personal exemption heightens the inequities that exist between individuals earning taxable wages and nonworking individuals receiving nontaxable social welfare benefits.

Given these facts, the federal government should reconsider its reasons for excluding social welfare payments from income taxation. As Table 1 illustrates, the federal government could raise a tremendous amount of revenue by taxing all social welfare benefits. The federal budget deficits invariably will lead the government to consider taxing those benefits. Moreover, the federal government almost certainly will need new revenues to pay for proposed reforms of the national health care system\textsuperscript{156} and the welfare system.\textsuperscript{157} Indeed, the Clinton administration is currently considering taxing food stamps, welfare benefits, and housing assistance.\textsuperscript{158} For that matter, any serious effort to reform the health and welfare systems will require reconsideration of the tax treatment of health and welfare benefits.

**B. Recent Developments**

1. **Taxation of Social Security Benefits**—For years, government listings of tax expenditures have identified the exclusion

\textsuperscript{154} Id. at 4. If the personal exemption were adjusted for inflation, it would exceed $3000. Id. at 5.


\textsuperscript{156} See, e.g., White House, Health Care Update, 93 Tax Notes Today 169-6, Aug. 13, 1993.

The federal government is heavily involved in providing health care assistance through Medicare, Medicaid, veterans benefits, the exclusion for employer-provided health insurance premiums, the deduction of health care costs, federal employee benefits, and other mechanisms. Indeed, in 1991, the federal government accounted for over 31% ($209.3 billion) of all personal health spending. 1993 Green Book, supra note 2, at 286. Additionally, health care costs are growing rapidly, both as a percentage of the gross domestic product and as a percentage of the federal budget. Moreover, some 35 million Americans, or 14.1% of the population, lack adequate health care coverage. Id. at 295. These are just some of the factors pushing the federal government towards developing a cost-effective and comprehensive health care plan.


\textsuperscript{158} See Jason DeParle, Clinton Considers Taxing Aid to Poor to Pay for Reform, N.Y. Times, Feb. 13, 1994, at A1.
of Social Security benefits as a major cause of lost revenue.\textsuperscript{159} Moreover, many tax analysts have recommended taxing a greater portion of Social Security benefits, so that they are taxed similarly to private pension plans.\textsuperscript{160} Consequently, in 1983, Congress began to tax a portion of Social Security benefits, and in 1993, it extended taxation to an even larger portion of Social Security benefits.\textsuperscript{161}

Further increases in the taxation of Social Security benefits are plausible. In its 1993 report outlining options for deficit reduction, the CBO discussed two ways to increase the taxation of Social Security benefits: (1) increase the fraction of benefits included in income; and (2) eliminate or reduce the $25,000 income threshold for singles and the $32,000 income threshold for couples.\textsuperscript{162} Table 2 shows that eliminating the income thresholds and taxing fifty percent of benefits would raise $43.6 billion over five years. Table 2 also shows that completely eliminating the income thresholds and taxing eighty-five percent of benefits would raise $112.5 billion over five years. Finally, Table 2 shows that retaining the $25,000 and $32,000 income thresholds and taxing eighty-five percent of benefits would raise $31.5 billion over five years.

President Clinton's original 1993 deficit reduction proposal approximated the last alternative—taxing eighty-five percent

\begin{itemize}
\item \textsuperscript{159} See supra Table 1 and text accompanying note 146.
\item One of the most common suggestions has been to tax Social Security benefits exactly like private pensions and annuities. Myers, supra note 109, at 1545. For example, an individual receiving benefits under a private pension plan usually excludes just a small fraction of those benefits from income. That fraction, known as the exclusion ratio, is based on the amount of after-tax contributions the individual made as an employee. The exclusion ratio enables the employee to recover his own after-tax contributions tax free and to pay tax only on the remaining portion of pension benefits which represents income. \textit{Id.} See I.R.C. § 72 (1988) (discussing the tax treatment of annuities).
\item \textsuperscript{161} See supra notes 104–111 and accompanying text.
\end{itemize}
### TABLE 2
**ANNUAL ADDED REVENUES FROM TAXING A GREATER PORTION OF SOCIAL SECURITY BENEFITS**

#### A. RETAIN THE CURRENT INCOME THRESHOLDS
Annual Added Revenues  
(Billions of Dollars)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase the Fraction of Benefits Included in Adjusted Gross Income to Tax up to 85% of Benefits</td>
<td>2.8</td>
<td>6.0</td>
<td>6.8</td>
<td>7.5</td>
<td>8.3</td>
<td>31.5</td>
</tr>
</tbody>
</table>

#### B. ELIMINATE THE INCOME THRESHOLDS
Annual Added Revenues  
(Billions of Dollars)

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Tax 50% Percent of Benefits</td>
<td>3.9</td>
<td>9.8</td>
<td>9.9</td>
<td>10.0</td>
<td>10.0</td>
<td>43.6</td>
</tr>
<tr>
<td>Tax 85% Percent of Benefits</td>
<td>10.06</td>
<td>24.1</td>
<td>25.0</td>
<td>25.9</td>
<td>26.9</td>
<td>112.5</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office, Options for Deficit Reduction (1993)
of benefits over the $25,000 and $32,000 thresholds. As enacted, the Omnibus Budget Reconciliation Act of 1993 adds a second tier of taxation: starting in 1994, single taxpayers with incomes over $34,000 and married couples with incomes over $44,000 will have to pay income taxes on as much as eighty-five percent of their Social Security benefits. The provision will raise roughly $25 billion over five years.

2. Taxation of the Insurance Value of Medicare Benefits—The exclusion of Medicare benefits also has been identified routinely as a tax expenditure. The federal government first began seriously to consider taxing Medicare benefits when it was looking for ways to finance the Catastrophic Health Insurance Act. The Bush Administration also considered taxing Medicare benefits. Neither effort came to fruition. Most recently, as one of its proposals for deficit reduction, the CBO also suggested taxing a larger portion of Medicare benefits.

There are a number of reasons to consider taxing Medicare benefits. The costs of the Medicare program have skyrocketed in recent years, and the contributions made by current beneficiaries will cover only a small portion of the costs of their expected lifetime benefits. Moreover, as Medicare is not


166. Staff of the Joint Comm. on Taxation, 103d Cong., 1st Sess., Estimated Budget Effects of H.R. 2264 as Agreed to by the Conferees 2 (Comm. Print 1993).

167. See supra notes 140-144.


170. 1993 CBO Options, supra note 144, at 365-66.

171. See 1993 Green Book, supra note 2, at 142 (indicating that total Medicare benefit payments have more than doubled from 1985 to 1992).

means-tested, many Medicare beneficiaries are relatively well-off. In effect, Medicare payroll taxes collected from low-income working taxpayers are being used to finance health care benefits for well-off retirees. According to one recent study, the annual value of the subsidy to current beneficiaries was at least $2100 per year, per person in dollars discounted to 1991. Thus, taxing the insurance value of Medicare benefits would have a leveling effect on this wealth disparity.

The broadest CBO proposal would tax up to half of the insurance value of Medicare Part A hospital insurance benefits and up to seventy-five percent of the insurance value of Medicare Part B supplementary medical insurance benefits. Table 3 demonstrates that this proposal would raise almost $55 billion over five years. The Congressional Budget Office also considered using the income thresholds of $25,000 for singles and $32,000 for couples to limit the application of the tax on Medicare benefits. This proposal would raise almost $31 billion over five years. In either case, the additional tax liability for taxpayers in or above the twenty-eight percent tax bracket could be substantial—as much as $817 in 1994 for single individuals and $1635 for couples.

Under current law, many employees are able to exclude the value of health insurance coverage for themselves and their families as well as the amount of any health insurance reimbursements for medical care they receive. Some might believe that it would be inequitable to tax the insurance value of Medicare benefits while retaining the exclusion for employer-provided insurance benefits. On the other hand, Medicare beneficiaries currently are not earning their coverage. Medicare benefits are best understood as coming only in part from the

173. Poverty is a much greater problems among children than it is among the elderly. See 1993 GREEN BOOK, supra note 2, at 1307–09 (discussing poverty rates by age and family type). Moreover, the elderly have greater wealth than younger taxpayers. See id. at 1559–60 (listing median net worth of householders by age).

174. Christensen, supra note 172, at 255.

175. See 1993 CBO OPTIONS, supra note 144, at 365. Eligibility for Medicare Part A is based upon payroll tax contributions, half of which are paid by employees from after-tax income and half of which are paid by employers from pretax income; hence, taxing 50% of the insurance value of Hospital Insurance would reflect the portion of contributions that was not taxed originally. With respect to Medicare Part B, participant premiums currently cover about 25% of the insurance value; hence, the remaining 75% of the insurance value could be added to participants’ taxable income.

176. 1993 CBO OPTIONS, supra note 144, at 366.

### TABLE 3

**ANNUAL ADDED REVENUES FROM TAXING A PORTION OF MEDICARE BENEFITS**

#### A. **WITHOUT INCOME THRESHOLD**

Annual Added Revenues
(Billions of Dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital Insurance Only</td>
<td>1.3</td>
<td>4.5</td>
<td>5.0</td>
<td>5.6</td>
<td>6.2</td>
<td>22.6</td>
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<tr>
<td>Supplementary Medical Insurance Only</td>
<td>1.5</td>
<td>5.3</td>
<td>6.1</td>
<td>7.2</td>
<td>8.5</td>
<td>28.6</td>
</tr>
<tr>
<td>Both</td>
<td>3.0</td>
<td>10.5</td>
<td>11.9</td>
<td>13.6</td>
<td>15.6</td>
<td>54.6</td>
</tr>
</tbody>
</table>

#### B. **WITH INCOME THRESHOLD**

Annual Added Revenues
(Billions of Dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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</thead>
<tbody>
<tr>
<td>Hospital Insurance Only</td>
<td>0.9</td>
<td>2.4</td>
<td>2.9</td>
<td>3.3</td>
<td>3.8</td>
<td>13.3</td>
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<td>Supplementary Medical Insurance Only</td>
<td>1.0</td>
<td>2.8</td>
<td>3.5</td>
<td>4.2</td>
<td>5.1</td>
<td>16.7</td>
</tr>
<tr>
<td>Both</td>
<td>2.0</td>
<td>5.3</td>
<td>6.4</td>
<td>7.7</td>
<td>9.1</td>
<td>30.6</td>
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</tbody>
</table>

Source: Congressional Budget Office, Options for Deficit Reduction (1993)
Medicare taxes paid by beneficiaries while they were working and in much larger part by transfers from the taxes paid by taxpayers currently in the work force.\textsuperscript{178}

3. Taxation of the Income-Replacement Portion of Workers' Compensation Benefits—The exclusion of workers' compensation benefits also has been identified routinely as a tax expenditure,\textsuperscript{179} and numerous tax analysts have recommended taxing the portion of workers' compensation benefits that replaces the injured employee's lost income.\textsuperscript{180} In 1977, the U.S. Department of Treasury noted that a model income tax would include workers' compensation benefits as income.\textsuperscript{181} In 1984, the U.S. Department of Treasury again recommended taxing the income replacement portion of worker's compensation,\textsuperscript{182} and in 1985 President Reagan formally made that recommendation to Congress,\textsuperscript{183} but such a provision was not enacted. In 1993, as yet another of its options for deficit reduction, the Congressional Budget Office suggested taxing the income replacement portion of workers' compensation benefits. The Congressional Budget Office estimates that this proposal would raise $20.2 billion over five years.\textsuperscript{184}

Taxing workers' compensation benefits would make their tax treatment more comparable to the treatment of unemployment benefits and employer-provided sick pay and disability pensions. It might not be fair, however, to tax workers' compensation benefits unless the exclusion for damages received on account of non-work-related injuries or sickness also was repealed.\textsuperscript{185} Taxing workers' compensation benefits also would give disabled workers a greater incentive to return to work.\textsuperscript{186} The tax might force some legislatures, however, to find the resources to increase benefit levels to offset the increased taxes paid on benefits.

4. Taxation of Public Assistance Benefits—The exclusion of public assistance benefits also has been identified routinely

\textsuperscript{178} See supra note 172 and accompanying text.
\textsuperscript{179} See supra notes 140–144.
\textsuperscript{180} One such proposal is found in Dodyk, supra note 132, at 794–800. For similar proposals see sources cited supra note 132.
\textsuperscript{181} See BLUEPRINTS, supra note 117, at 59.
\textsuperscript{182} See 1984 TREASURY REPORT, supra note 120, at 51–57.
\textsuperscript{183} See REAGAN TAX PROPOSAL, supra note 121, at 49–56.
\textsuperscript{184} 1993 CBO OPTIONS, supra note 144, at 357. That portion of workers’ compensation and Black Lung benefits which reimburses employees for medical costs (about 40%) would continue to be exempt from taxation. Id.
\textsuperscript{185} See I.R.C. § 104(a)(2) (1988). I would support such a change.
\textsuperscript{186} Work disincentives arise any time the value of tax-free benefits approach the after-tax value of the wages that an individual can earn. See Feldstein, supra note 117, at 241–43.
as a tax expenditure,\textsuperscript{187} and several tax analysts have argued for inclusion of means-tested benefits in income.\textsuperscript{188} In 1977, the U.S. Department of Treasury noted that a model income tax would include in income all cash transfer payments from the government, whether means-tested or not.\textsuperscript{189} Thus far, however, there has not been a serious public proposal to tax means-tested public assistance benefits.\textsuperscript{190}

The basic argument for taxing public assistance benefits is one of equity: people with the same income should be taxed equally.\textsuperscript{191} The failure to tax public assistance benefits is thought to favor unfairly recipients of this type of income over other individuals who earn less and whose income is further diminished by taxes. Proponents argue that the program should tax public assistance benefits and use those tax revenues to increase benefits for the most needy.\textsuperscript{192}

Standard deductions and personal exemptions already ensure that almost no low-income taxpayers actually pay any income tax. A taxpayer's standard deduction and personal exemptions combine to establish a simple income tax threshold; a taxpayer owes no income tax unless the taxpayer's income exceeds the applicable income tax threshold.\textsuperscript{193} Table 4 compares the U.S. Department of Health and Human Services' so-called poverty income guidelines\textsuperscript{194} with these simple income tax thresholds for family units of up to eight persons.

\begin{thebibliography}{99}
\bibitem{187} See supra notes 140–144.
\bibitem{188} See, e.g., sources cited supra note 132.
\bibitem{189} See BLUEPRINTS, supra note 117, at 61.
\bibitem{190} The Bush administration considered taxing food stamps and welfare benefits, but nothing resulted from it. See Wessel, supra note 169, at A2. The Republican administration apparently did not want to be accused of "taxing the poor." It should be noted that the Clinton Administration currently is considering a proposal to tax welfare benefits. See supra note 157 and accompanying text.
\bibitem{191} See, e.g., Pechman, Erosion of the Individual Income Tax, supra note 132, at 12–14.
\bibitem{192} See, e.g., Dodyk, supra note 132, at 794–800.
\bibitem{193} For example, in 1993, a family of four consisting of a husband and wife filing a joint tax return with two dependents would be entitled to a $6200 standard deduction and four $2350 personal exemptions. See Rev. Proc. 92-102, 1992-2 C.B. 579, 579–80. Consequently, the family would not have to pay any income tax until its income exceeded $15,600.

The poverty income guidelines are a simplified version of the federal government's statistical poverty thresholds used by the Census Bureau to prepare statistical estimates of the number of persons and families in poverty. Each year, the Department of Health and Human Services updates its poverty income guidelines to reflect the prior year's change in the Consumer Price Index. These poverty income guidelines are used as eligibility criteria by a number of social welfare programs. See id. at 8288.
### TABLE 4
RELATIONSHIP BETWEEN POVERTY INCOME GUIDELINE AND SIMPLE INCOME TAX THRESHOLDS, 1993

<table>
<thead>
<tr>
<th>Size and Type of Family Unit</th>
<th>Applicable Poverty Income Guideline</th>
<th>Simple Income Tax Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$6970</td>
<td>$6050</td>
</tr>
<tr>
<td>1 (over 65 or blind)</td>
<td>$6970</td>
<td>$6950</td>
</tr>
<tr>
<td>2 (head of household and 1 child)</td>
<td>$9430</td>
<td>$10,150</td>
</tr>
<tr>
<td>2 (couple)</td>
<td>$9430</td>
<td>$10,900</td>
</tr>
<tr>
<td>3 (head of household and 2 children)</td>
<td>$11,890</td>
<td>$12,500</td>
</tr>
<tr>
<td>3 (couple and child)</td>
<td>$11,890</td>
<td>$13,250</td>
</tr>
<tr>
<td>4 (couple and 2 children)</td>
<td>$14,350</td>
<td>$15,600</td>
</tr>
<tr>
<td>5 (couple and 3 children)</td>
<td>$16,810</td>
<td>$17,950</td>
</tr>
<tr>
<td>6 (couple and 4 children)</td>
<td>$19,270</td>
<td>$20,300</td>
</tr>
<tr>
<td>7 (couple and 5 children)</td>
<td>$21,730</td>
<td>$22,650</td>
</tr>
<tr>
<td>8 (couple and 6 children)</td>
<td>$24,190</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

Table 4 shows that for family units larger than one, the simple income tax threshold exceeded the applicable poverty income guideline in 1993; that is, all families with incomes below the applicable poverty income guideline were not subject to federal income taxation. Even single individuals did not owe any income tax unless the individual’s taxable income exceeded $6050, $920 below the applicable poverty line.

Thus, because standard deductions and personal exemptions already protect low-income taxpayers from virtually any income tax liability, the current exclusion of public assistance benefits does almost nothing more to help them. Instead, virtually all of the tax savings from the exclusion of public assistance benefits inure to taxpayers who are decidedly not low-income. Put simply, the exclusion of public assistance benefits does not

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195. These simple income tax thresholds ignore the impact of the earned income credit. Factoring in the earned income credit for those taxpayers who qualify for the credit would result in even higher thresholds. For example, in 1992, a married couple with two dependent children had a simple income tax threshold of $15,200 ($6000 standard deduction plus four $2300 personal exemptions). When the impact of the earned income credit was taken into account, however, that family had no income tax liability until its income reached $18,548. See 1993 GREEN BOOK, supra note 2, at 1477.
help the most needy individuals and greater equity could be achieved by taxing the public assistance benefits received by higher-income taxpayers and redistributing those revenues to lower-income taxpayers. 196

On the other hand, public assistance benefits already are targeted to the most needy through means testing by way of benefit-reduction formulae. If public assistance benefits were subject to income taxation, the combination of income taxes, Social Security taxes, and benefit-reduction rates would result in an extraordinarily high cumulative marginal tax rate for some individuals. 197 Such high marginal tax rates can and assuredly do discourage people from working and offer the most compelling reason not to tax public assistance benefits, or at least to figure out how to better synchronize the tax and welfare systems. 198

The failure to tax public assistance benefits, however, itself results in disincentives to work. As previously noted, 199 work disincentives arise any time the value of tax-free benefits approach the after-tax value of the wages that an individual can earn. 200 For example, many recipients of AFDC and food stamps actually fare worse economically if they work at low-wage jobs than if they remain on welfare. After paying income and Social Security taxes, some low-wage workers will have less after-tax income than welfare will provide, and leaving welfare results in the termination of valuable Medicaid benefits for the worker and the worker’s family. Consequently, taxing AFDC and Medicaid benefits might help to avoid such work disincentives.

196. This point is even more compelling with respect to such non-means-tested benefits as Social Security and Medicare. Standard deductions and personal exemptions would protect all low-income Social Security beneficiaries from income tax liability on their benefits. For example, in 1993, an elderly couple will not have to pay any income tax unless the couple’s taxable income exceeds $12,300 (the sum of a $6200 basic standard deduction, two $700 additional standard deductions for the elderly, and two $2350 personal exemptions). Thus, if Congress were to eliminate the income floors and tax 85% of Social Security benefits, an elderly couple whose only source of income was Social Security benefits would not pay any income tax until the couple received more than $14,470 in Social Security benefits ($14,470 x 85% = $12,300). In comparison, the Department of Health and Human Services’ 1993 poverty income guideline for a family of two is just $9430. Poverty Guidelines, supra note 194, at 8288.

197. See, Jonathan B. Forman, Does Bill Clinton Really Mean to Subject Elderly Workers to Confiscatory Tax Rates?, 59 TAX NOTES 119, 120 (1993) (finding cumulative marginal tax rates as high as 100% for certain elderly workers).

198. See Forman, Administrative Savings, supra note 1, at 4–8 (noting that synchronization may solve the problem of high marginal tax rates).

199. See supra note 186 and accompanying text.

200. See Feldstein, supra note 117, at 241–43.
Moreover, the low participation rates associated with most forms of public assistance raise another important equity question. Only about sixty percent of the poor participate in the food stamp program;\textsuperscript{201} only about sixty percent of poor children are covered by AFDC;\textsuperscript{202} and only about sixty percent of the elderly poor participate in SSI.\textsuperscript{203} Thus, the failure to tax public assistance tends to increase the differences between the disposable incomes of welfare program participants and nonparticipants who struggle in low-paying jobs to earn a living. Consequently, taxing public assistance benefits would temper that inequity.

Unfortunately, taxing public assistance benefits would increase the complexity of the tax laws.\textsuperscript{204} In addition, taxing in-kind benefits such as Medicaid, food stamps, and housing assistance would require valuation and thus could create administrative difficulties. There has been a good deal of research on valuation of social welfare benefits, and the problems of valuation may not be insurmountable.\textsuperscript{205} One solution would be to replace most in-kind benefits with equivalent cash benefits.\textsuperscript{206} Alternatively, in-kind benefits like food stamps could simply be valued according to their face amounts.\textsuperscript{207}

CONCLUSION

The federal government's huge public debt and its annual deficits invariably will push it to consider income taxation of social welfare benefits as a means of raising needed revenues.

\textsuperscript{201} 1993 \textit{GREEN BOOK}, \textit{supra} note 2, at 1621.  
\textsuperscript{202} \textit{Id.} at 688.  
\textsuperscript{203} \textit{Id.} at 845.  
\textsuperscript{204} See Sunley, \textit{supra} note 117, at 104. Presumably, social welfare agencies would have to withhold taxes from benefit awards and comply with a variety of IRS information reporting requirements.  
\textsuperscript{207} Notably, this alternative would help discourage the resale and misuse of food stamps.
Efforts to reform the health and welfare systems also should cause the federal government to reconsider how the tax system treats social welfare benefits. Workers' compensation and Medicare benefits are the most likely targets for income taxation, but even such public assistance programs as AFDC, Medicaid, and food stamps may soon come under the Congressional revenue-raisers' scrutiny.