Memorandum

To: Biden-Harris Agency Review Teams for Labor, NEC, and Treasury

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Re: Preventing Taxation of Pandemic Unemployment Benefits through Executive Action

Brief Summary

In order to avoid $1,000+ surprise tax bills for millions of out-of-work Americans, Treasury should establish as a day one priority new guidance clarifying that most forms of added unemployment assistance authorized in 2020 are not taxable. Because many states will already have sent contrary information to beneficiaries by January 20 based on a mistaken legal assumption, the Department of Labor should also issue guidance to states to send corrected follow-up information, and Labor should additionally make small grants to help states do so.

Detailed Analysis

Over the course of 2020, Congress has authorized four forms of novel assistance for individuals who have lost work: PUA (for part-time and gig workers, and others ineligible for traditional UI benefits), FPUC (a flat $600 added weekly payment for UI recipients), PEUC (full federal funding for an extended duration of UI benefits), and LWA (a stopgap program that replaced expired UI benefits). In addition, Congress authorized full federal financing of EB (the existing Extended Benefits program that provides additional weeks in states where unemployment is high enough and whose funding is typically split equally between states and the federal government). In many states, individuals have been advised to elect withholding of federal tax on these benefits, on the assumption that, like traditional UI benefits, they would be federally taxable. Some self-employed individuals also made quarterly tax payments on this assumption. However, many individuals will not have elected to have tax withheld or paid estimated taxes on their benefits, and they will likely owe additional tax on their 2020 returns.

1. Novel COVID UI benefits are likely not taxable

There is a strong legal argument that none of the benefits authorized as part of the pandemic response are taxable. I.R.C. § 139(b)(4) excludes from income any payment from any "Federal, State, or local government…in connection with a qualified disaster in order to promote the general welfare. . . ." COVID-19 has been declared a qualifying disaster, and the benefits were provided in response.

These benefits plainly come from a qualifying source. The only question is whether they are paid "in order to promote the general welfare." In our view, the effort to provide economic stimulus meets the plain English definition of "promote the general welfare." Further, "general welfare" is a term of art in tax law, and longstanding I.R.S. rulings hold that unemployment insurance benefits indeed are payments to promote the general welfare. Rev. Rul. 63-136; GCM 34424 (Feb. 8, 1971).

This interpretation is not without some doubt, as we analyze further in the legal appendix. However, since in our view it is more likely than not that taxpayers would ultimately prevail on this question in court, it is highly desirable to avoid unnecessary litigation and deliver tax relief to affected households as soon as possible. We do believe, however, that the argument for tax exemption is not as strong with respect to traditional unemployment insurance benefits, which are not as clearly paid "in connection with a qualified disaster." Thus, our recommendations focus on the four novel benefits. We note, though, that the logistical difficulties are much more manageable if Treasury takes the position that all post-Covid benefits, including traditional UI, are exempt.

2. Millions of households and $17B+ at stake

While UI income is typically taxable, federal income tax withholding is not required. States are required to offer a standard withholding rate (10%) to UI beneficiaries, but they must opt-in to withholding. As a result, many UI beneficiaries do not have federal taxes withheld from their UI benefit payments. Though the Department of Labor and the IRS cautioned states and workers about the taxability of these benefits, states were not required to offer the withholding option for benefits from the four novel UI programs enacted this year. This is likely to result in millions of households owing taxes next year.

Below, we outline several income and tax liability scenarios for workers who received UI income this year. For simplicity, we omit analysis of LWA, as it was not available uniformly in all states.

Scenario 1: If a *single worker with no dependents who made the average weekly wage* ($972.08) was laid off on March 15th, in the initial wave of Covid-19 closure orders, she would have received $10,693 in wage income before being laid off. Her effective annual tax rate (if she'd worked at that wage all year) would be 8.7%, and we assume her federal income tax withholding for the weeks she was employed would have been $926. After being laid off, if she received the average UI weekly benefit amount ($373.54) for 26 weeks, the typical maximum number of weeks for state UI, she would have received $9,712 in state UI benefits. In addition, she would have received the $600 FPUC supplement for 17 weeks, totaling $10,200. After exhausting state UI benefits, she received 13 weeks of PEUC benefits and 2

weeks of EB payments, totaling $5,603. Her total federally financed UI income in 2020 would be $15,803, and her total UI income would be $25,515. With her wage income, her total income would be $36,208. She did not opt-in to withholding on any UI benefits, so ***she would owe approximately $1,733 in federal income taxes***.

Scenario 2: If a *single worker with no dependents made the average weekly wage* and was laid off on March 15th, but his *employment was categorized as self-employment*, he would have received $10,693 in net self-employment income before being laid off. After being laid off, if he received the average PUA weekly benefit ($212) for 39 weeks, the maximum number of weeks allowed in most states, he would have received $8,268 in PUA benefits. Additionally, he received the $600 FPUC supplement for 17 weeks, totaling $10,200. His total UI income, entirely federally financed, in 2020 was $18,468. With his wage income, his total income would be $29,161. His state did not offer withholding for PUA or FPUC payments. We assume he made an estimated tax payment to cover the self-employment taxes he owes on his self-employment income. ***He would owe approximately $1,485 in federal income taxes***.

Scenario 3: If a *married worker who files jointly with no dependents made the average weekly wage* and was laid off on March 15th, he would have received $10,693 in wage income before being laid off. He withheld $926 before being laid off. If he received the average state UI payment for 12 weeks, the maximum duration for his state, he would have received $4,482 in state UI income. He received the $600 FPUC supplement for 17 weeks, totaling $10,200. Following the exhaustion of state benefits, he received 13 weeks of PEUC benefits and 6 weeks of EB benefits, and 8 weeks of PUA benefits, exhausting the state and federal UI benefits available to him. His total federal UI income would be $20,286. His state offered 10% withholding for state benefit payments only, so he withheld $448. His spouse earned the average weekly wage for all 52 weeks ($50,548 in total) and withheld $4,379. Their tax liability is approximately $6,950 and their combined withholding is $5,753, leaving them with an ***estimated outstanding federal income tax liability of $1,197***.

In each of these scenarios, households would reap huge benefits from UI income tax exemption.

Scenario 1:

a) If all UI income were exempted from federal taxes: She would receive a refund of $1,320, a net benefit of $3,053.
b) If UI income from federally financed programs were exempted from federal taxes: She would receive a refund of $126, a net benefit of $1,859.

Scenario 2:

a) Only the second situation applies; he would receive a refund of about $58, a net benefit of $1,543.

Scenario 3:

a) They would receive a refund of $1,775, a net benefit of $2,972.
b) They would receive a refund of $1,237, a net benefit of $2,434.

The Treasury and Labor Departments do not publish data on the withholding rates of UI beneficiaries, though after conversations with state UI offices, *we believe take-up of withholding is low*, especially among recipients of federal benefits. As of December 15, 2020, over $512 billion has been paid out in unemployment insurance benefits this year. Due to the generosity of the FPUC program, the lengthy average duration of unemployment (23 weeks), the percent of jobless workers claiming PUA (45%), and the percent of jobless workers claiming benefits through UI extension programs (27%), a large proportion of these payments are likely due to federally financed UI programs.

Using the middle quintile average effective federal individual tax rate from 2017 (3.3%), ***exempting all UI payments from federal income tax would result in approximately $17 billion in reduced tax liabilities***. Approximately ***40 million workers*** have received some amount of UI income this year and ***could benefit from this policy***. Given that job losses have been disproportionally concentrated among lower income households and workers of color, the benefits of tax exemption would likely aid households most in need of support.

3. Administrative considerations requiring DoL attention

In the event the Treasury Secretary determines that PUA, FPUC, PEUC, and LWA are not taxable, prompt action will be needed in order to minimize burdens on taxpayers. By the end of January, most states will have issued Form 1099-G information returns informing taxpayers and IRS of the amount of taxable UI benefits received. We anticipate that these forms will not separately state the proportion of benefits from state and federal programs, as there is only a single box for unemployment compensation on the 1099-G. Thus, even if the guidance we recommend is issued by late January, neither taxpayers nor IRS will likely be able to determine the correct amount of taxable income. A careful tax preparer with sufficient information could infer an individual's state UI benefit amount based on their qualifying wages at the time of separation, and then algebraically determine the tax-free balance.

We think it would be preferable for states, who already hold all the necessary information, to issue an updated mailing providing a detailed breakdown of benefits

by program type. The Secretary of Labor should issue guidance requiring that states send UI beneficiaries the breakdown of their benefits and an explanation of what amount is taxable. The Department of Labor and the IRS should work jointly on this guidance to ensure taxpayers are equipped with the information to accurately and efficiently report their UI income on tax filings, expediting the refund payments resulting from this exemption. These data could also be shared with IRS in database form.

To assist states with the costs associated with the data reporting and communication to beneficiaries, the Department of Labor could provide small grants from the UI trust fund, using its statutory authority to make grants for administrative purposes.

In the event that supplemental state mailings cannot be made in time for tax filing season, several other options are possible. For one, the Secretary could allow households to elect to delay filing by several months. Alternately, she may establish a safe harbor, such as allowing all households to exclude the first $10,200 (the maximum possible FPUC amount) in 1099-G reported unemployment benefits.

Legal Appendix

As stated above, there is a potential argument that all of the benefits we have analyzed should be taxable. First, we note that I.R.C. § 85, which states that payments "in the nature of unemployment insurance" are taxable income, does not require treating the benefits as taxable. Section 85 merely states the general rule, to which *disaster* benefits are an exception, as provided in § 139. Section 139 would supersede § 85, as it does any other provision providing that certain benefits are taxable as a general rule.

A possible source of the mistaken belief that unemployment benefits provided in connection with a qualified disaster are taxable is the Joint Committee on Taxation's technical explanation of § 139. Section 139 was originally enacted as part of the Victims of Terrorism Tax Relief Act of 2001, a tax relief package for victims of September 11, and was rushed through Congress at the end of December of that year. There is no legislative history to speak of. The technical explanation suggests that the language "in order to promote the general welfare" in section 139 excludes income replacement benefits. It states that "As under the present law general welfare exception, the exclusion does not apply to payments in the nature of income replacement, such as payments to individuals of lost wages, [or] unemployment compensation…."

But the JCT was mistaken about whether the general welfare exception applies to unemployment/income replacement benefits, and thus whether the term

"in order to promote the general welfare" in the new section 139 excluded such benefits from that section's broader tax exclusion for disaster benefits. Although the technical explanation provides citations in support of the sentence we quoted, those citations do not support its claim, and indeed do not even contain the words "general welfare" or "unemployment." As we have already said, IRS repeatedly held that unemployment benefits were in fact excluded from income under the "general welfare" doctrine, an administratively-created exception that exempts from income most payments from governments to individuals. For example, GCM 34424 (Feb. 8, 1971) states:

> While exclusions from income generally have been limited to those areas specified in the Code, one deviation from the general pattern has been in the area of the so-called welfare payment-disbursements made from a general welfare fund in the interest of the general welfare. See I.T. 3230, C.B. 1938-2, 136, which holds that payments on account of unemployment paid by a State agency out of funds received from the Federal Unemployment Trust Fund are not subject to Federal income tax in the hands of the recipients.

It was in response to these rulings that Congress adopted § 85 in 1978. See H.R. Conf. Rep. 95-1800, at 7219. Notably, § 85 does not attempt to define "general welfare," but instead simply states that payments in the nature of unemployment benefits are taxable.

The existence of this prior interpretation by the IRS would make it difficult to argue that § 139 singles out unemployment insurance payments for taxation. When a tax statute uses terms of art, it is presumed to incorporate prior interpretations unless those interpretations are expressly repealed. *Comm'r v. Kowalski*, 434 U.S. 77, 92–93 (1977). A mistaken legal interpretation in a technical explanation is certainly not express repeal. As IRS has acknowledged, § 139 "codifies (but does not supplant) …the administrative general welfare exclusion with respect to certain disaster relief payments to individuals." Rev. Rul. 2003-12.

Even if it were the case that § 139 were understood to require taxation of unemployment compensation, there is still an argument that FPUC payments would be excludable. Because benefits under FPUC are not based on wage history, they are distinguishable from the unemployment compensation familiar to Congress in 2001. Arguably, they are more like a lump-sum stimulus check, albeit targeted to workers who meet UI program eligibility – and therefore squarely the type of payment "based on need," Rev. Rul. 2003-12 that the general welfare exclusion covers.

Therefore, we believe it is likely both that taxpayers would challenge any IRS effort to tax PUA, FPUC, PEUC, or LWA benefits, and that they would likely

prevail. While the IRS could conceivably defend a position that the benefits are taxable, especially if it were to issue new guidance after notice and comment, that outcome has no policy appeal. These are households who are out of work and either cannot afford a surprise tax bill or would have a very high marginal propensity to spend a refund check. Forcing them instead to wait years—shifting the refund to a time when there is unlikely to be a recession—and requiring them to incur substantial litigation costs, makes no sense. The position we recommend does not expand the general welfare exception, a step Treasury has long been reluctant to undertake, but instead only relies on longstanding interpretations of it.

The outcome is not as clear for state UI benefits. As we noted, it is less evident that traditional UI is paid "in connection with" the COVID disaster. The statute does not state how directly payments must be connected to a triggering disaster. Arguably, one or two additional links in a causal chain are still "in connection with" the ultimate cause. At least for individuals in industries most impacted by the pandemic, we think there is thus a plausible legal position that state UI benefits should also be exempt under § 139, assuming that one also concludes that the JCT technical explanation is not conclusive. We anticipate taxpayers will also litigate this issue.