Is California's "Middle Class Tax Refund" Taxable?

By David M. Fogel, EA, CPA

Introduction

On June 30, 2022, California enacted the Better for Families Tax Refund[1], which added various sections to the California Revenue & Taxation Code ("R&TC") and the California Welfare and Institutions Code.

This legislation added Chapter 4.9 to the California Welfare and Institutions Code ("W&IC"), called the Better for Families Act ("the Act").

Under the Act, the Franchise Tax Board ("FTB") is authorized to make a one-time payment to a qualified recipient based on the recipient's 2020 individual income tax return. The amount of the payment varies from $200 to $1,050 depending upon the recipient's adjusted gross income, filing status, and whether a dependent was listed on the return.

The Act specifically provides that the payments are excludable from California gross income. However, there is no guidance from the IRS as to whether the payments are taxable for Federal income tax purposes.

This article examines whether the payments may be excluded under the Federal "general welfare exclusion."

The Better for Families Act

The Act provides for the FTB to make the following payments as soon as possible after June 30, 2022:

Single or married/RDP filing separately		
AGI reported on 2020 CA return	With dependent	Without dependent
$75,000 or less	$700	$350
$75,001—$125,000	$500	$250
$125,001—$250,000	$400	$200
$250,001 or more	Not qualified	Not qualified

Married/RDP filing jointly		
AGI reported on 2020 CA return	With dependent	Without dependent
$150,000 or less	$1,050	$700
$150,001—$250,000	$750	$500
$250,001—$500,000	$600	$400
$500,001 or more	Not qualified	Not qualified

Head of household or qualifying widow(er)		
AGI reported on 2020 CA return	With dependent	Without dependent
$150,000 or less	$700	$350
$150,001—$250,000	$500	$250
$250,001—$500,000	$400	$200
$500,001 or more	Not qualified	Not qualified

The payment is based on the recipient's 2020 individual income tax return, which must have been filed by October 15, 2021.[2] The recipient must also be a California resident on the date that the payment is issued, a California resident for at least 6 months during 2020, and not be claimed as a dependent by another taxpayer.[3]

If an individual without a Tax Identification Number (TIN) applied for a TIN by October 15, 2021 but had not received it by that date, then the individual must have filed the 2020 return by February 15, 2022.[4]

A single individual without any dependents who is either incarcerated or deceased at the time that the payment is authorized is not eligible for the payment.[5]

The payment has been called the "Middle Class Tax Refund" even though this term is not used anywhere in the legislation, and the Act specifically states that the payment is not a tax refund.[6]

According to its website, the FTB made some of the payments by direct deposit between October 7, 2022 and November 14, 2022, and some by debit cards mailed between October 24, 2022 and January 14, 2023.

[1] Assembly Bill 192, Chapter 51.

[2] W&IC §8161(b)(4)(A).

[3] *Id.*

[4] W&IC §8161(b)(4)(B).

[5] W&IC §8161(b)(4)(C).

[6] W&IC §8161(d).

Section 10 of Assembly Bill 192 ("AB 192") explains the purpose for the payments:

> **SEC. 10.** Increased costs for goods, including gas, due to inflation, supply chain disruptions, the effects of the COVID-19 emergency, and other economic pressures have had a significant negative impact on the financial health of many Californians. The Legislature hereby finds and declares that the payments authorized by Chapter 4.9 (commencing with Section 8160) of Division 8 of the Welfare and Institutions Code, as added by this act, serve the public purpose of providing financial relief for Californians who may have been adversely impacted by these economic disruptions and do not constitute gifts of public funds within the meaning of Section 6 of Article XVI of the California Constitution.

In addition, the Senate and Assembly legislative analyses of the bill state that the purpose of the payment is "to provide financial relief for economic disruptions resulting from the COVID-19 emergency, such as the financial burdens of inflation and increasing costs for gas, groceries, and other necessities."[7]

The Act specifically states that the payments are excludable from California gross income.[8]

According to its website, the FTB states that the payments "may be considered federal income" and that as a result, it will issue Form 1099-MISC for any payment of $600 or more.[9]

The General Welfare Exclusion

IRC §61(a) states that except as otherwise provided, gross income means all income from whatever source derived.

However, the IRS has consistently concluded that certain payments to individuals by governmental units under legislatively provided social benefit programs for the promotion of the general welfare of the public (i.e., based on need) are not includible in gross income.[10] The exclusion of such payments from gross income has become known as the "general welfare exclusion."

To qualify under the general welfare exclusion, payments must (1) be made from a governmental fund, (2) be for the promotion of general welfare (i.e., generally based on individual or family needs such as housing, education, and basic sustenance expenses), and (3) not represent compensation for services.[11]

Assistance to help disaster victims meet necessary expenses or serious needs in the categories of medical or dental, housing, personal property, transportation, and funeral expenses qualifies for the general welfare exclusion, but assistance for nonessential, luxurious, or decorative items does not qualify.[12]

Payments to compensate individuals for the extra reasonable and necessary personal, living, and family expenses they incur due to a disaster or emergency situation are also excluded from gross income under the general welfare exclusion.[13]

Notice 2002-76 explains the requirement that the payments must be based on individual or family needs as follows:

> Governmental payments to help individuals and families meet disaster-related expenses are based on need. For example, Rev. Rul. 76-144, 1976-1 C.B. 17, holds that grants made under the Disaster Relief Act of 1974 to help individuals or families affected by a disaster meet extraordinary disaster-related necessary expenses or serious needs in the categories of medical, dental, housing, personal property, transportation, or funeral expenses (and not in the categories of nonessential, decorative, or luxury items) are excluded from gross income under the general welfare exclusion. In this context, because "need" is not defined in terms of financial need, the general welfare exclusion applies equally to all residents of an affected area regardless of their income levels. In the absence of a disaster, however, governmental payments made without regard to financial status, health, educational background, or employment status are not based on need and, thus, do not qualify under the general welfare exclusion. See Rev. Rul. 76-131, 1976-1 C.B. 16; and Rev. Rul. 85-39, 1985-1 C.B. 21.

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[7] See the Senate Floor Analysis and the Assembly Floor Analysis dated June 28, 2022.

[8] R&TC §17131.12.

[9] https://www.ftb.ca.gov/about-ftb/newsroom/middle-class-tax-refund/help.html

[10] See, for example, Rev. Rul. 74-205, 1974-1 C.B. 20 (state payments to adoptive parents for support and maintenance of an adopted child); Rev. Rul. 75-271, 1975-2 C.B. 23 (mortgage assistance payments under section 235 of the National Housing Act); Rev. Rul. 76-144, 1976-1 C.B. 17 (a grant received under the Disaster Relief Act of 1974); Rev. Rul. 98-19, 1998-15 I.R.B. 5 (relocation payment to move from a residence damaged by a flood).

[11] Rev. Rul. 2005-46, 2005-30 I.R.B. 120; Rev. Rul. 82-106, 1982-1 C.B. 16; Rev. Rul. 75-246, 1975-1 C.B. 24. See also Letter Ruling 201743010.

[12] Rev. Rul. 76-144, 1976-1 C.B. 17.

[13] Notice 2002-76, 2002-48 I.R.B. 917 (Q&A-1 and Q&A-2). See also Rev. Proc. 2014-35, 2014-26 I.R.B. 1110.

Do the Payments Satisfy the Requirements of the General Welfare Exclusion?

AB 192 created the Better for Families Tax Refund Fund in order to provide funds for the payments.[14] This satisfies the first requirement of the general welfare exclusion, i.e., that the payments must be made from a governmental fund.

Section 10 of AB 192 and the Senate and Assembly legislative analyses of the bill state that the purpose of the payments is to provide financial relief for economic disruptions resulting from the COVID-19 pandemic such as inflation and increased costs for gas, groceries, and other necessities. This appears to satisfy the second requirement of the general welfare exclusion, i.e., that the payments must be based on individual or family needs such as housing, education and basic sustenance expenses.

It could be argued that a payment to an individual with an adjusted gross income of $500,000 doesn't appear to be based on "need." But Notice 2002-76 states that "need" is not defined in terms of financial need and that "the general welfare exclusion applies equally to all residents of an affected area regardless of their income levels."

It could also be argued that because there has been no "disaster," the payment is taxable. But section 10 of AB 192 specifically states that the payment is to provide financial relief resulting from the COVID-19 pandemic, and on March 13, 2020, president Trump declared the COVID-19 pandemic as a federal disaster.[15]

In short, I believe that based on section 10 of AB 192 and the legislative analyses, a good argument can be made that the payment satisfies the second requirement of the general welfare exclusion.

A recipient is not required to perform any services in order to receive the payment. This satisfies the third requirement of the general welfare exclusion.

Others' Opinions Regarding the Taxability of the Payments

In a podcast, Spidell Publishing, LLC, a private California tax analysis and education company that is well-respected in California, stated that the payments are taxable for Federal income tax purposes.[16]

However, subsequently, Spidell acknowledged in its tax update manual that the general welfare exclusion could possibly apply.[17]

At any rate, the opinions of tax professionals (including mine) do not constitute substantial authority that may be relied upon for purposes of the accuracy-related penalty.[18]

How to Claim the General Welfare Exclusion

If a client receives a Form 1099-MISC from the FTB reporting the payment, and you wish to exclude the payment from gross income based on the general welfare exclusion, then you should report the payment as "other income" on Form 1040, Schedule 1, line 8z, and exclude it as an "other adjustment" on Form 1040, Schedule 1, line 24z.

Conclusion

In my opinion, a good argument could be made that the payment under the Act is excludable from gross income based on the general welfare exclusion.

Hopefully, the IRS will issue guidance in the future that reaches the same conclusion.

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[14] See W&IC §8162.

[15] See Notice 2020-18, 2020-15 I.R.B. 590.

[16] "Podcast: Middle Class Tax Refunds aren't really tax refunds" (December 16, 2022).

[17] *2022/2023 Federal and California Tax Update*, p. 8-2

[18] Treas. Reg. §1.6662-4(d)(3)(iii).