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Oversight Hearing to Examine the Federal Tax Treatment of Health Care Benefits Provided by Tribal Governments to Their Citizens

Application of the General Welfare Exclusion to Health Care Provided by Federally Recognized Indian Tribes to Their Members

Mr. Chairman and members of the Committee allow me to thank you for the invitation to present testimony on the question of whether the value of tribally provided health care is included in the gross income of tribal members for purposes of the federal income tax. I have concluded that the general welfare exclusion, an administrative practice that the Internal Revenue Service (IRS) has developed through rulings, operates to exclude the value of tribally provided health care from the gross income of members. In addition, I have concluded that exclusion of these benefits is justified as a matter of federal Indian law because the United States has undertaken the obligation to provide health care to Native Americans as a general treaty obligation through the Indian Health Service (IHS). If tribes determine that, compared to IHS, they can provide better health care through private health insurance or direct reimbursements for health care, then tribal health care should receive the same federal income tax treatment as medical care provided through IHS. IRS has provided no explanation of why it excludes the value of IHS care coverage from the gross income of Native Americans receiving such care.

Some Federal Income Tax Background

In terms of understanding the federal income tax questions involved, we need to focus on the benefits that IRS may treat as gross income. The underlying transaction involves a

federally recognized Indian tribe that purchases health insurance for its members. Under this health insurance arrangement, an individual tribal member may receive health care that the health insurance pays for directly or through reimbursement. Under section 104(a)(3) of the Internal Revenue Code, amounts received through health insurance to cover medical care are excluded from the gross income of the person receiving the health care. Section 104(a)(3) does not apply to employer provided health care. The rules for employer provided health are contained in section 105 and, generally speaking, provide rules of exclusion similar to those in section 104(a)(3). As a result, section 104(a)(3) operates to exclude the value of the health care that a tribal member actually receives under the health insurance arrangement.

However, no federal income tax provision deals with the cost of health care that a tribe purchases on behalf of individual members. For example, if a tribe pays a health insurance provider $7,000 per year for comprehensive health insurance for each tribal member requesting such coverage, then IRS may assert that the tribe is conferring a benefit on the member in the amount of $7,000 each year. This $7,000 is gross income, IRS would argue, because the benefit goes to the tribal member and because Congress has provided no statutory rule of exclusion. The result is different if a tribal member receives health insurance coverage as an employee of the tribe. In the case of a tribal employee, section 105 excludes the cost of the health insurance from the member's gross income. Likewise, if a tribal member is self-employed, then section 162(l) allows the individual to deduct the cost of the health insurance as an above-the-line business expense effectively giving the same treatment as the exclusion provided in section 105. See IRC § 62(a)(1) (allowing the health insurance cost of self-employed individuals as an above-the-line deduction; see IRS Form 1040 for 2008, line 29).

Without a specific statutory exclusion to protect a tribal member from an aggressive IRS auditor, the amount a tribe pays for health insurance on behalf of a tribal member may be treated as the gross income of that member. IRS, however, has discovered that many types of governmental payments not covered by a specific statutory rule of exclusion should be excluded. The most often used theory of exclusion is the "general welfare exclusion" (sometimes also described as the "general welfare exemption").

The General Welfare Exclusion

Most law professors teach their students that gross income includes all income from whatever source derived. As a general concept, income is any realized benefit or accession to wealth over which the taxpayer has dominion and control. This concept comes from the Supreme Court case of *Commissioner v. Glenshaw Glass,* 348 U.S. 426 (1955), and applies to all potential income unless the taxpayer can find a specific statute that provides a rule of exclusion. See *Vincent v. Commissioner,* T.C. Memo 2005-95 (construing rules of statutory exclusion narrowly). This sweeping characterization of the federal income tax is so over

inclusive that IRS has been forced to develop some explicit and some implicit rules of exclusion, without which our federal income tax would collapse.

The broadest explicit administrative rule of exclusion that IRS uses is the "general welfare exclusion" (GWE). IRS, back when it was called the Bureau of Revenue, developed this doctrine in 1938 to provide for the exclusion of lump sum payments made under the Social Security Act. See I.T. 3194, 1938-1 C.B. 114. By 1971 IRS referred to GWE as a long-standing doctrine. See GCM 34506 (May 26, 1971) (providing exclusion of federal mortgage assistance payments). The United States Tax Court seems to acknowledge that GWE may provide a basis of exclusion in appropriate cases. See *Bannon v. Commissioner,* 99 T.C. 59 (1992) (refusing to apply GWE in a case where a relative was paid to care for a disabled relative but acknowledging its possible application under appropriate facts).

In applying the general welfare exclusion, the IRS generally requires that the payments 1) come from a governmental general welfare fund, 2) be spent to promote general welfare, and 3) not be based on payment for service rendered. See Rev. Rul. 98-19, 1998-1 C.B. 840 (excluding relocation payments made by local governments to those whose homes were damaged by floods). The second requirement (promotion of general welfare) must be based on the need of the recipient; however, the need can be based on a variety of considerations including "financial status, health, educational background, or employment status." IRS CCA 200021036 (May 25, 2000) (excluding state adoption assistance payments made to those individuals adopting special needs children even though not based on any financial means test applied to the adoptive parents). IRS has applied GWE to tribal payment and has acknowledged that tribes are governments within our legal system and capable of setting aside and making payments out of a "governmental welfare fund." See PLR 200632005 (April 13, 2006) (excluding tribal funds expended for housing assistance allocated based on multiple factors of need); compare Tec. Adv. Memo. 9717007 (Jan. 13, 1997) (including as gross income those per capita payments made by a tribe to its members when the amount of the payments were made without regard to the health, education, or employment status of individual members) .

The question here is whether tribes can provide health care, through health insurance or through a reimbursement plan, to all members without regard to the financial needs of their members. IRS, in some of their audits, is asserting that tribal health plans provided to all members may produce gross income to recipients because the benefits are not based on financial need. If IRS is making such an assertion, then such an assertion is wrong. Health care is provided to prevent and treat disease. Those receiving medical treatment receive such treatment because they have a need for it. Those at risk of contracting breast cancer, for example, should receive regular screening. Those not at risk do not require such screening. Those who have a chronic disease, such as diabetes, require and need medical treatment to

mitigate the effects of such a disease. It is entirely appropriate for IRS to treat all health care as need based because it treats or prevents illness. Providing this health care through health insurance is a prudent way for a tribe to manage costs. Such an arrangement benefits from risk pooling and should lower the overall costs of health care.

IRS currently treats the value of health care received through Medicare, the Veterans Administration, and the Indian Health Service as excluded from gross income. Except in the case of Medicare, IRS has not provided any rulings and Congress has not enacted any statutes providing a specific exclusion for these benefits. See Rev. Rul. 79-172, 1979-1 C.B. 86 (applying the general welfare exclusion to Medicare benefits). Health care under these federal plans is not provided based on financial need. Medicare is based solely on age. Coverage through the Veterans Administration is based on past military service, although some medical services are based on financial need. Care though IHS depends on an individual's status as an Indian without regard to wealth or income. See 42 C.F.R. § 136.12 (describing eligibility based on status as a Native American and not based on financial need).

Senator John McCain, a member of your Committee, qualifies for health insurance through his service as a United States Senator, through the VA based on his military service, and through Medicare based on his years on this earth. None of these programs is means tested. Nonetheless, the value of these benefits, if equated to health insurance, is not included in his gross income. To single out Native Americans as the only group of Americans who should treat as gross income the value of governmentally provided health care would be unfair. The health care needs of Native Americans are just as real and substantial as those over 65, those who have served in the military, and those Native Americans who are members of tribes that cannot afford health care for their members and who must seek care through the Indian Health Service.

Treaty Exemption

IRS takes the position that tribal members are subject to the federal income tax unless specifically exempted by treaty or statute. See Rev. Rul. 67-284, 1967-2 C.B. 55. Congress has provided no statutory rule of exclusion for the benefit a member receives when the tribe pays for the member's health insurance. See IRC §§ 105 & 106 (applying rules of exclusion to employer provided health care but not to tribes or other health care provided through government programs, such as Medicare).

The Indian Health Service exists primarily because many treaties obligated the United States to provide health care to the members of tribes. The Indian Health Service explains that treaties "between the United States Government and Indian Tribes frequently call for the provision of medical services, the services of physicians, or the provision of hospitals for the

care of Indian people." See IHS Facts Sheets, available at http://info.ihs.gov/BasisHlthSvcs.asp. If health care is a federal treaty obligation and if tribes are willing to provide their members with better health care through the purchase of private health insurance, then it makes sense to honor the treaty obligation and to treat tribally provided health care benefits as excluded from gross income for purposes of the federal income tax. It would be strange to allow tribal members to exclude the value of IHS medical care but to tax the value of tribally provided care, especially when it lessens the federal obligation owed.

Conclusion

The general welfare exclusion is a sufficient and adequate legal theory to exclude the benefits of health care provided by tribes to their members. The difficulty comes from IRS auditors and revenue agents who view all tribal benefits as gross income unless provided based on financial need. The criteria of need used by IRS acknowledge that an allocation of benefits based on health, education, or employment status is just as appropriate as one based on financial status. In this case, the health of a tribal member is the need, and tribal health insurance meets the health needs of tribal members. Therefore, the general welfare exclusion clearly applies. To clarify this situation and to instruct IRS agents in the field, IRS should issue a revenue ruling. This ruling should hold that the cost of health insurance provided by tribes to their members is excluded from gross income under the general welfare exclusion.

In addition, the federal treaty obligation to provide health care to Native Americans is an independent legal basis for excluding the cost of health care provided by tribes. Tribes that choose to purchase health insurance for their members should be allowed to step into the shoes of the federal government and provide medical services to members. Treating tribal health benefits the same as those that the Indian Health Services provides is just and fair. This treatment would validate tribal sovereignty and enhance the government-to-government relationship that the United States has with Native American governments.