TAXING NUDGES

*Kathleen DeLaney Thomas**

Governments are increasingly turning to behavioral economics to inform policy design in areas like health care, the environment, and financial decision-making. Research shows that small behavioral interventions, referred to as "nudges," often produce significant responses at a low cost. The theory behind nudges is that, rather than mandating certain behaviors or providing costly economic subsidies, modest initiatives may "nudge" individuals to choose desirable outcomes by appealing to their behavioral preferences. For example, automatically enrolling workers into savings plans as a default, rather than requiring them to actively sign up, has dramatically increased enrollment in such plans. Similarly, allowing individuals to earn "wellness points" from attendance at a gym, redeemable at various retail establishments, may improve exercise habits.

A successful nudge should make a desired choice as simple and painless as possible. Yet one source of friction may counteract an otherwise well-designed nudge: taxation. Under current tax laws, certain incentives designed to nudge behavior are treated as taxable income. At best, people are ignorant of taxes on nudges, an outcome that is not good for the tax system. At worst, taxes on nudges may actively deter people from participating in programs with worthy policy goals. To date, policymakers have generally failed to account for this potential obstacle in designing nudges.

This Article sheds light on the tax treatment of nudges and the policy implications of taxing them. It describes the emergence of a disjointed tax regime that exempts private party nudges, but taxes identical incentives that come from the government. What is more, an incentive

* George R. Ward Term Professor of Law, University of North Carolina School of Law. I am grateful to Andrew Benton for excellent research assistance, and to helpful comments from Ellen Aprill, Peter Barnes, Fred Bloom, Michelle Drumbl, Heather Field, Brian Galle, Brant Hellwig, Andy Hessick, Carissa Hessick, Ed McCaffery, Pat Oglesby, Leigh Osofsky, Gregg Polsky, Katie Pratt, Rich Schmalbeck, Ted Seto, Jay Soled, Sloan Speck, Manoj Viswanathan, Larry Zelenak and workshop participants at University of Colorado Law School, Duke Law School, Loyola Law School, Washington & Lee University School of Law, and UC Hastings College of Law. For Tessie DeLaney.

structured as a government grant may be taxable while an economically identical tax credit is not. The Article then proposes reforms that would unify the tax treatment of nudges and enhance their effectiveness. Specifically, lawmakers should reverse the default rule that all government transfers are taxable, and instead exclude government transfers from income unless otherwise provided by the Tax Code.

INTRODUCTION

Imagine that every ten years, a flood decimates the banks of a river, destroying homes and other buildings in its wake. Each time, the flood causes millions of dollars of damage and leaves some people homeless or jobless. The local government incurs enormous costs in the aftermath to clean up damage and provide subsidies to victims.

Now imagine that experts determine that a measure can be taken to "flood proof" homes and other buildings. The measure costs several thousand dollars per building, but this pales in comparison to the cost of cleaning up flood damage. Naturally, policymakers would be eager to encourage residents along the riverbank to undertake the improvements. But people tend to be present-biased and discount future harms, and the residents are unmotivated to make the improvements.[1] What can policymakers do?

One option would be to mandate flood proofing and penalize those who do not do it. But this would be politically unpopular and entail enforcement costs. Another option would be simply to pay for the flood proofing for each resident; but this may be cost prohibitive.

There may be a third option, however. Suppose that lawmakers decide to offer a small carrot—a "nudge"—to encourage people to flood proof

[1] See infra Subsection I.B.6.

their homes. They might, for example, offer a modest cash reward—say $300—for doing so. Or they might offer to provide a warranty for any flood damage incurred after the improvement is made. The small nudge may be enough to motivate people to flood proof their homes. If the nudge is effective, the government might succeed in protecting its residents' homes at a fraction of the cost of using penalties or paying for the improvements outright.

Nudges are an increasingly popular policy tool in many contexts. Insights from behavioral economics reveal that people's irrational tendencies may lead them to make suboptimal decisions, such as failing to flood proof their homes, opting not to save for retirement, or not applying to college. For example, people's failure to save for retirement is often just due to sheer inaction—what researchers call "status quo bias,"[2] rather than any rational decision about how to spend one's money. Making retirement savings easier by defaulting people into savings plans is an example of a simple nudge that achieves a desired policy at a low cost.

The term "nudge" was famously coined by Professors Richard Thaler and Cass Sunstein to describe an intervention that "alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives."[3] Nudges might make a desired choice easier or simpler for people, they might help people overcome bad habits like procrastination, or they may simply provide people with better information.[4] Governments around the world have increasingly used nudges to enact cost-effective policies to improve the welfare of their citizens.

Nudges come in many forms: shifting defaults, like in the case of savings plans; sending people text message reminders to apply for college financial aid; or simplifying instructions on forms. Other nudges provide small incentives, like cash rewards or "wellness points" one might earn for achieving health goals. Regardless of the form of a particular nudge, it should make a desired choice as simple and painless as possible.

Yet one source of friction may counteract an otherwise well-designed nudge: taxation.

---

[2] See infra note 15 and accompanying text.

[3] Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness 6 (2d ed. 2009).

[4] Cass R. Sunstein, Misconceptions About Nudges, 2 J. Behav. Econ. for Pol'y 61, 61 (2018).

Under current tax laws, certain incentives aimed at nudging behavior are treated as taxable income. While nudges like defaults or text message reminders do not have tax consequences, nudges that provide an economic benefit to the recipient may be taxable. This is true regardless of whether the benefit comes in the form of cash, property, or services. For example, if a local government offers its citizens a $300 reward for flood proofing their homes, that grant would be subject to federal income taxation.

At best, people are ignorant of taxes on nudges, an outcome that is not good for the tax system. It may be particularly counterintuitive to people that government grants would be subject to tax. At worst, taxes on nudges may actively deter people from participating in programs with worthy policy goals. For example, homeowners may decide to forego a cash reward for flood proofing their home because they do not want to deal with the hassle of reporting it or because they do not want to attract scrutiny from the IRS. To date, policymakers have generally failed to account for this potential obstacle in designing nudges.

This Article sheds light on the tax treatment of nudges and the policy implications of taxing them. It first describes the emergence of a disjointed tax regime that often exempts nudges that come from private parties, but taxes identical incentives that come from the government. As a default, the tax law generally treats all economic benefits as taxable income. However, broad exceptions exist for certain incentives provided by employers to their employees, which are often classified as nontaxable fringe benefits. Similarly, incentives paid by nonprofits to individuals are likely to be treated as nontaxable gifts. Nudges provided by businesses to paying customers are also exempt from tax under the judicially created "purchase price adjustment" doctrine.

When it comes to identical incentives provided by governments, however, none of the fringe benefit, gift, or purchase price adjustment exclusions apply. Furthermore, while many government transfers are exempt from tax under other exclusions—for example, welfare assistance, veterans' benefits, Social Security, and Medicare—those rules do not cover most nudges. Without a special exclusion, incentive-based nudges provided by governments are generally subject to tax under current laws. This regime does not appear to be a product of design, but is more likely the result of a piecemeal system of tax exemptions that has developed over time. Perhaps even more confounding is that an incentive structured as a government grant may be taxable, while an economically identical tax credit is not.

After examining the tax treatment of the most common types of nudges, this Article proposes reforms that would unify the tax treatment of nudges and enhance their effectiveness. It argues that lawmakers should reverse the default rule that all government transfers are taxable, and instead provide a rule that government transfers are excluded from income unless otherwise provided by the Tax Code. This would ensure that nudges designed to promote worthy policy goals would be exempt from tax as a default matter, unless Congress specifically decides otherwise. As an alternative to this broad proposal, the Article also proposes legislation that would exempt specific nudges from tax in the areas of health and environmental protection. Under either approach, exempting nudges from tax will make them more effective and should not pose serious revenue consequences.

This Article proceeds in four parts. Part I describes the concept of a nudge and categorizes the most common types of nudges. Part II provides an overview of the tax system and discusses the current tax treatment of nudges. Part III discusses policy implications of the current tax regime, including proposals to reform the tax treatment of nudges. Part IV concludes that the simplest, yet most effective, way to unify the tax treatment of nudges would be for Congress to provide a default of nontaxability for government transfers.

I. BACKGROUND ON NUDGES

This Part describes the concept of a "nudge" in more detail and discusses the most common types of nudges.

A. What are Nudges?

Policymakers may wish to change the behavior of citizens for myriad reasons. For example, people may make poor health choices that impose costs on the health care system, or they may engage in activities that damage the environment. When seeking to modify behavior, the classic tools from economics are penalties and subsidies.[5] An example of the former would be a statute that bans littering and imposes a fine for

[5] See, e.g., George Loewenstein & Nick Chater, Putting Nudges in Perspective, 1 Behav. Pub. Pol'y. 26, 29 (2017) ("Traditional economic interventions include taxes, subsidies and mandatory disclosure of information . . . .").

violations; an example of the latter would be a tax credit for driving a fuel-efficient car. The effectiveness of penalties and subsidies varies by context.[6] In general, however, these measures can impose significant costs on governments. Subsidies must be paid for and result in direct revenue loss, while fines may impose indirect costs such as increased enforcement and the potential "crowding-out" of voluntary compliance.[7]

In recent years, insights from behavioral economics have suggested a third alternative to penalties and subsidies.[8] As researchers learn more about human behavior and how people make judgments, they have observed that sometimes a "gentle hint"[9] or "nudge" can have as much influence on behavior as a mandate or a financial subsidy can.[10]

As an illustration, consider what is perhaps the best-known and widely praised policy nudge to date: automatic enrollment in savings plans.[11] Researchers, and eventually lawmakers, set out to increase enrollment in workplace savings plans like a 401(k). Rather than requiring workers to sign up for a plan and decide how much to contribute (i.e., a default of no enrollment), the default was shifted to automatic enrollment in a savings plan.[12] Under the new default, unless workers opt out of the plan or alter their rate of contribution, they will automatically start saving.[13] The simple act of shifting this default dramatically increased enrollments in savings plans.[14] It appears the default election helps people overcome "status quo bias," that is, the human tendency to avoid change.[15]

---

[6] See, e.g., David Halpern, Inside the Nudge Unit: How Small Changes Can Make a Big Difference 4 (2015).

[7] See, e.g., Bruno S. Frey, A Constitution for Knaves Crowds Out Civic Virtues, 107 Econ. J. 1043, 1044–45 (1997).

[8] Cass R. Sunstein, Nudging: A Very Short Guide, 37 J. Consumer Pol'y 583, 583 (2014) (Nudges "generally cost little and have the potential to promote economic and other goals . . . .").

[9] Halpern, supra note 6, at 22.

[10] Brian Galle argues that, in some circumstances, nudges are the most efficient choice of instrument. See Brian Galle, The Problem of Intrapersonal Cost, 18 Yale J. Health Pol'y, L., & Ethics 1, 32–50 (2018).

[11] Sunstein, supra note 8, at 585. However, for a critique of savings defaults, see Ryan Bubb & Richard H. Pildes, How Behavioral Economics Trims Its Sails and Why, 127 Harv. L. Rev. 1593, 1607–37 (2014).

[12] Thaler & Sunstein, supra note 3, at 110–11.

[13] Id. at 111.

[14] See, e.g., id. at 111–13 (automatic enrollment increased employee participation in savings plans from 65% to 90%, and could notably increase per-capita contribution percentages); Loewenstein & Chater, supra note 5, at 27.

[15] Daniel Kahneman, Jack Knetsch & Richard Thaler, Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias, 5 J. Econ. Persp. 193, 197–98 (1991).

Governments have increasingly adopted nudges as cost-effective ways to promote public policy. The Obama Administration created a "Social and Behavioral Sciences Team," ("SBST") which conducted over thirty pilot programs that applied behavioral insights to government policy.[16] For example, the SBST partnered with the Department of Education's office of Federal Student Aid ("FSA") to send a series of low-cost, personalized text messages to low-income students to remind of them of the steps needed to complete the college application process.[17] This simple intervention resulted in a 5.7 percentage point increase in overall college enrollment.[18]

The United Kingdom has adopted behavioral economics into government policy even more extensively, establishing a Behavioral Insights Team in 2010 (also known as the "Nudge Unit") that has conducted hundreds of studies to date.[19] Among many successful interventions, the UK's Nudge Unit has increased payment of local taxes through appeals to social norms, reduced prescription medication errors by redesigning prescription forms, and increased voter registration rates through the use of a lottery.[20]

Many other countries, including Germany, Canada, Australia, Denmark, France, and the Netherlands, have also adopted their own version of a nudge unit.[21] Although not all behaviorally informed

[16] See About SBST, SBST, https://sbst.gov/#report [https://perma.cc/S3YM-35MC] (last visited June 14, 2019).

[17] William J. Congdon & Maya Shankar, The White House Social & Behavioral Sciences Team: Lessons Learned from Year One, 1 Behav. Sci. & Pol'y 77, 83 (2015), https://behavioralpolicy.org/wp-content/uploads/2017/05/BSP_vol1is2_Congdon.pdf [https://perma.cc/EXF9-RWMV].

[18] Id.

[19] See About Us, Behavioural Insights Team, https://www.bi.team/about-us/ [https://perma.cc/6BUF-95PA] (last visited Nov. 7, 2020) ("We have run more than 750 projects to date, including 400 randomised controlled trials in dozens of countries.").

[20] See Christopher Larkin, Michael Sanders, Isabelle Andresen & Felicity Algate, Testing Local Descriptive Norms and Salience of Enforcement Action: A Field Experiment to Increase Tax Collection, 2 J. Behav. Pub. Admin. 1, 9–10 (2019); Dominic King et al., Redesigning the "Choice Architecture" of Hospital Prescription Charts: A Mixed Methods Study Incorporating In Situ Simulation Testing, 4 BMJ Open 1, 8–9 (2014); Peter John, Elizabeth MacDonald & Michael Sanders, Targeting Voter Registration with Incentives: A Randomized Controlled Trial of a Lottery in a London Borough, 40 Electoral Stud. 170, 175 (2015).

[21] See Zeina Afif, William Wade Islan, Oscar Calvo-Gonzalez & Abigail Goodnow Dalton, World Bank Group, Behavioral Science Around the World: Profiles of 10 Countries 6 (2019), http://documents.worldbank.org/curated/en/710771543609067500/pdf/132610-REVISED-00-COUNTRY-PROFILES-dig.pdf [https://perma.cc/JDX2-R9UK].

interventions have been successful,[22] governments continue to experiment with ways to incorporate behavioral economics into policy design.[23]

B. Types of Nudges

This Section surveys research on various types of nudges and provides examples of specific behavioral interventions. The discussion also groups nudges together into different categories. As will be discussed further in Part II, some types of nudges have tax implications and others do not, and grouping various behavioral interventions into categories will assist with that analysis. These categories, which are by no means exhaustive, include nudges based on defaults, simplification, appeals to social norms, information, and incentives.

This Article uses the term "nudge" broadly to include any intervention that does not rely on traditional economic incentives. Other commentators may define nudge more narrowly. Furthermore, as discussed below, the line between what constitutes a nudge and what constitutes a subsidy may sometimes be hard to draw, and some incentives involve a mix of economic and non-economic considerations. Importantly, these definitional issues do not have tax implications and do not impact the analysis herein. In other words, if an incentive is taxable, it is taxable regardless of whether it is properly characterized as a nudge or a subsidy.

1. Defaults

For a variety of psychological reasons—procrastination, present bias, and the power of inertia—defaults are powerful drivers of human choice.[24] The simple act of shifting defaults to desired outcomes, while preserving the choice to opt out of the default, has had a significant policy impact, as demonstrated in the case of retirement savings discussed above. Defaults have been employed as nudges in numerous other settings as well. For example, changing default settings to double-sided printing reduces paper consumption,[25] and requiring people to opt out of organ

[22] See, e.g., Congdon & Shankar, supra note 17, at 84 (finding that letters sent to physicians comparing their prescribing rates with those of their peers had no measurable impact on prescription rates).

[23] See Afif et al., supra note 21, at 8–9.

[24] See, e.g., Thaler & Sunstein, supra note 3, at 12, 85.

[25] See, e.g., Johan Egebark & Mathias Ekström, Can Indifference Make the World Greener? 11–13 (Rsch. Inst. of Indus. Econ., IFN Working Paper No. 975, 2013).

donation drastically increases the participation rate compared to an opt-in system.[26]

2. Simplification

Reducing the cognitive burden of decision making also appears to help people make better choices. Oftentimes, complexity may stand as a barrier to participating in government programs that are otherwise in peoples' financial interest.[27] With this in mind, some nudges are designed to simplify existing forms or processes.

One experiment examined the impact of simplification of the Free Application for Federal Student Aid (FAFSA), which is an eight-page form with over 100 questions, necessary for students that want financial aid to attend college.[28] As compared to individuals who did not receive assistance, a treatment group that received a simplified version of the form, prepopulated with tax return information, was significantly more likely to submit the aid application.[29]

3. Information

Related to simplification is the idea that providing people with more information, or information that is easier to access and understand, can also improve decisions. Some nudges involve better disclosure. For example, after finding that car consumers are not good at understanding how fuel economy relates to cost, the Environmental Protection Agency and Department of Transportation required new disclosures from car manufacturers, to better inform people.[30] The revised disclosure label clearly states the projected annual fuel cost, as well as the projected five-year savings or costs of the car compared to the average new car.[31]

Other nudges relate to the timing of information. For example, sending text message reminders to people shortly before they are scheduled to

[26] Eric J. Johnson & Daniel Goldstein, Do Defaults Save Lives? 302 Science 1338, 1338–39 (2003).

[27] See, e.g., Sunstein, supra note 8, at 585.

[28] Eric P. Bettinger, Bridget Terry Long, Philip Oreopoulos & Lisa Sanbonmatsu, The Role of Simplification and Information in College Decisions: Results from the H&R Block FAFSA Experiment 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 15361, 2009), https://www.nber.org/papers/w15361.pdf [https://perma.cc/XBV6-DL2U].

[29] Id. at 26–27.

[30] Cass R. Sunstein, Empirically Informed Regulation, 78 U. Chi. L. Rev. 1349, 1372–73 (2011).

[31] Id. at 1373.

appear in court significantly reduces the number of people who fail to appear, thereby reducing warrants.[32] Similarly, a reminder email sent to federal student loan borrowers who missed their first student loan payment increased the percentage of people making a payment.[33]

Other informational nudges rely on salience, the idea that people may respond differently to a message depending on how visible or noticeable it is.[34] One example is the innovation of signing at the top for self-reporting on forms. Researchers found that moving the signature line from the bottom of a form to the top, i.e., asking people to sign to verify the form's accuracy *before* they fill it out rather than after, leads to more honest reporting.[35] The theory behind the nudge is that asking people to sign the form at the beginning makes the ethical component of the signature more salient, and leads people to consider ethical obligations as they fill out the form.[36]

Governments also frequently rely on salience when it comes to warning labels. Cigarette labels, for example, are often designed with highly salient language and graphics, in an attempt to more successfully influence consumers.[37]

4. Appeals to Social Norms

Appealing to social norms—the idea that people are influenced by what others around them are doing—is also a successful nudge in some contexts. The UK's Nudge Unit improved tax compliance by sending

[32] See, e.g., New Text Message Reminders for Summons Recipients Improves Attendance in Court and Dramatically Cuts Warrants, Ideas42, https://www.ideas42.org/new-text-message-reminders-summons-recipients-improves-attendance-court-dramatically-cuts-warrants/ [https://perma.cc/5SMM-PPFH] (last visited June. 17, 2019) (finding that text message reminders in New York City reduced "failure to appear" rates by 26%).

[33] See Congdon & Shankar, supra note 17, at 83.

[34] See, e.g., Raj Chetty, Adam Looney & Kory Kroft, Salience and Taxation: Theory and Evidence, 99 Am. Econ. Rev. 1145, 1165 (2009).

[35] Lisa L. Shu, Nina Mazar, Francesca Gino, Dan Ariely & Max H. Bazerman, Signing at the Beginning Makes Ethics Salient and Decreases Dishonest Self-Reports in Comparison to Signing at the End, 109 Proc. Nat'l Acad. Sci. 15197, 15197–98 (2012), http://www.pnas.org/content/109/38/15197.full.pdf+html [https://perma.cc/436E-DGL2]

[36] Id. at 15198.

[37] See, e.g., Sunstein, supra note 30, at 1381; Kate Phillips, Applying Behavioral Science Upstream in the Policy Design Process, Behav. Scientist (Sept. 17, 2018), https://behavioralscientist.org/applying-behavioral-science-upstream-in-the-policy-design-process/ [https://perma.cc/UWJ5-BBC7] (describing new laws implemented in Australia, requiring graphic images on cigarette labels, to reduce smoking rates).

people letters informing them that most citizens pay their taxes on time.[38] Similarly, informing people how their energy usage compares to that of their neighbors appears to have a positive impact: consumers reduced their energy usage when they were informed theirs was higher than average.[39]

5. Incentives

Traditional economic incentives are, by definition, not nudges.[40] For example, imagine it would cost an individual $10,000 to install solar panels on her house. Further imagine that the benefit of the panels, including the value added to her home and the energy cost savings during the time she is expected to live in the home, is worth $8000. Without a subsidy, the homeowner will not want to spend $10,000 for an $8000 benefit, and thus she will not install the panels. But if the government offers her a $3000 tax credit for installation of the panels, making the net cost only $7000, she may decide to install the panels. [41] In this case, the individual was not nudged to install the solar panels, she was simply responding to a financial incentive to do so.

Notwithstanding the fact that traditionally defined nudges "must not impose significant material incentives,"[42] many nudges do provide some form of incentive. Often the incentive comes in the form of property (e.g., a prize) or services. Other nudges may provide small cash incentives, sometimes referred to as "micro-incentives."[43] Generally, what distinguishes a small cash incentive from an economic subsidy is that, with the former, the response is driven by some psychological

[38] Michael Hallsworth, John A. List, Robert D. Metcalfe & Ivo Vlaev, The Behavioralist as Tax Collector: Using Natural Field Experiments to Enhance Tax Compliance 4 (Nat'l Bureau of Econ. Research, Working Paper No. 20007, 2014), https://www.nber.org/papers/w20007 [https://perma.cc/W7LN-F2T2].

[39] Hunt Allcott, Social Norms and Energy Conservation, 95 J. Pub. Econ. 1082, 1082–83 (2011).

[40] Sunstein, supra note 4, at 61 (distinguishing between nudges, which "must preserve freedom of choice," and subsidies or other interventions, which "impose[] significant material costs on choosers").

[41] This is assuming economically rational decision making on behalf of the homeowner, without factoring in other (realistic) costs, such as hassle costs and present bias.

[42] Sunstein, supra note 4, at 61.

[43] See Robert Münscher, Max Vetter & Thomas Scheuerle, A Review and Taxonomy of Choice Architecture Techniques, 29 J. Behav. Decision Making 511, 518 (2016) (defining micro-incentives as "changes of the consequences of decision options that are insignificant from a rational choice perspective").

phenomenon, rather than a rational cost-benefit analysis.[44] For example, imagine that a $5 cash payment encouraged people to get a free flu vaccine. The payment might work because it is salient and immediate, but it is less likely that $5 acts as a true economic subsidy, as compared to the above example of the solar panels.[45]

a. Health

Incentive-based nudges are frequently employed in the context of improving health decisions.[46] One common example is workplace wellness programs, which are offered by about half of employers in the United States.[47] The theory behind the programs is that by providing employees with incentives to make healthy lifestyle choices, like proper diet and exercise, they will be more productive and impose fewer healthcare costs.[48]

Wellness plans come in a range of sizes and forms, with the most comprehensive plans offered by large companies providing medical personnel onsite.[49] More commonly, employer wellness plans offer a range of screenings and incentives to keep employees active and healthy.

---

[44] Id.

[45] The small size of the payment makes it particularly less likely to function as a true subsidy, although it could. For example, if paying for bus fare to a local clinic was the impediment to a person obtaining a free flu shot, the $5 may operate as an economic subsidy free of behavioral considerations. For further discussion of the distinction between nudges and subsidies, see Brian Galle, Tax, Command . . . or Nudge?: Evaluating the New Regulation, 92 Tex. L. Rev. 837, 854–56 (2014) (explaining that "surprising and asymmetric incentives" are one factor distinguishing nudges from subsidies, and using a five-cent tax on plastic bags as an example of a financial consequence that is most likely a nudge, given that alternatives are generally more costly than the bag tax).

[46] Bronwyn McGill, Blythe J. O'Hara, Anne C. Grunseit & Philayrath Phongsavan, Are Financial Incentives for Lifestyle Behavior Change Informed or Inspired by Behavioral Economics? A Mapping Review, 33 Am. J. Health Promotion 131, 131 (2019) ("Since the 1960s, financial incentives (FIs) have been used in behavior change interventions, targeting a broad spectrum of health issues such as blood donation, medication adherence, and health and wellness programs.").

[47] Soeren Mattke et al., Workplace Wellness Programs Study: Final Report, at xiv (Rand Corp. ed. 2013); see also Laura A Linnan, Laurie Cluff, Jason E. Lang, Michael Penne & Maija S. Leff, Results of the Workplace Health in America Survey, 3 Am. J. Health Promotion 652, 655 (2019) (over 46% of worksites surveyed had wellness programs).

[48] See Ha T. Tu & Ralph C. Mayrell, Employer Wellness Initiatives Grow, But Effectiveness Varies Widely, Nat'l Inst. for Health Care Reform, July 2010, at 2 (concluding that employers offer wellness programs to contain medical costs, to improve productivity, and to "position themselves as 'employers of choice'").

[49] Id.

For example, many plans offer free health risk assessments and biometric screenings, like cholesterol or blood pressure tests.[50] Some plans offered by large employers also offer free services to employees in the form of health coaching, smoking cessation programs, or weight loss programs.[51] For example, some employers offer free Weight Watchers meetings onsite.[52] Others may offer reduced or free gym memberships, or onsite fitness facilities.[53] Health related seminars and other educational programs are also routine offerings.[54]

Financial incentives are also a common feature of wellness plans,[55] with 84% of employers who offer plans offering rewards of some kind.[56] One common financial incentive is a reduction or reimbursement of insurance premiums, offered in exchange for participation in wellness initiatives.[57] Other programs offer cash rewards;[58] for example, an employee might be paid a certain dollar amount for every percentage of body weight lost.[59] Employers also frequently offer non-cash rewards, like gift certificates or other novelty items (e.g., a T-shirt), to participating employees.[60]

---

[50] Id. at 2–3.

[51] Id. at 3–4.

[52] Mattke et al., supra note 47, at xv.

[53] Tu & Mayrell, supra note 48, at 5; Bahaudin G. Mujtaba & Frank J. Cavico, Corporate Wellness Programs: Implementation Challenges in the Modern American Workplace, 1 Int'l J. Health Pol'y & Mgmt. 193, 194 (2013) (mentioning gym reimbursements as a part of corporate wellness programs).

[54] See, e.g., Mujtaba & Cavico, supra note 53, at 194 (listing seminars as a part of corporate wellness programs).

[55] These wellness program incentives are regulated by several laws. For example, the Health Insurance Portability and Accountability Act ("HIPAA") imposes multiple nondiscrimination requirements. See Tu & Mayrell, supra note 48, at 6.

[56] Mattke et al., supra note 47, at 73 fig.5.3.

[57] Tu & Mayrell, supra note 48, at 5; see also Mujtaba & Cavico, supra note 53, at 196 (referencing "[h]ealth insurance discounts and reimbursements for employees who meet health standards and maintain a healthy lifestyle").

[58] One report found that "[m]ost benefits consultants and wellness vendors believed that $100 is the 'sweet spot' for an incentive for a 'single instance of behavior,' such as HRA completion or participation in a specific wellness activity." See Tu & Mayrell, supra note 48, at 5.

[59] John Cawley & Joshua A. Price, A Case Study of a Workplace Wellness Program That Offers Financial Incentives for Weight Loss, 32 J. Health Econ. 794, 795 (2013).

[60] Mattke et al., supra note 47, at xxi.

Even in the case of cash incentives, these programs often act more like nudges than subsidies.[61] In the case of weight loss, for example, present bias[62] may prevent people from attaining their goals.[63] Cash rewards may help people overcome these psychological obstacles because such rewards are salient and immediate, while weight loss itself is not.[64]

Finally, it should be noted that some wellness plan strategies are not incentives at all, but rather resemble the other types of nudges described above. For example, some employers have undertaken measures like moving parking lots farther from the building or improving stairwells to encourage more walking.[65] Another common workplace nudge is replacing food in the vending machines and/or cafeteria with healthier choices.[66]

Incentive-based nudges to promote health extend beyond workplace wellness programs, as well. For example, hospitals in the United States and Canada have recently experimented with rewarding substance abusers when they stay clean.[67] One program in British Columbia offers an eight-week program, during which time participants can pull a chip out of a hat once a week if their drug test is negative.[68] The chips are worth 5, 20, or 100 Canadian dollars, and are redeemed for prizes like gift cards at local restaurants or stores.[69] A similar program at Veteran's Affairs hospitals in the United States runs for twelve weeks and allows

[61] But see Katherine Pratt, A Constructive Critique of Public Health Arguments for Anti-Obesity Soda Taxes and Food Taxes, 87 Tul. L. Rev. 73, 77–94 (2012) (discussing economic, externality-based justifications for anti-obesity taxes and subsidies).

[62] Present bias describes the tendency to value immediate rewards over future rewards, even if the future rewards are larger. See, e.g., Richard Thaler, Some Empirical Evidence on Dynamic Inconsistency, 8 Econ. Letters 201, 201 (1981). In the context of weight loss, it is hard for people to forego immediate benefits (a tasty meal, for example) in exchange for a future benefit (lower weight).

[63] See Cawley & Price, supra note 59, at 794 ("[P]eople may want to do what is in their long-run interest (lose weight), but consistently succumb to the temptation to eat and be sedentary.").

[64] Id.

[65] Tu & Mayrell, supra note 48, at 5.

[66] Id.

[67] Sahil Gupta, Opinion, Earning Prizes for Fighting an Addiction, N.Y. Times (Mar. 12, 2019), https://www.nytimes.com/2019/03/12/opinion/earning-prizes-for-fighting-an-addiction.html [https://perma.cc/58CN-DT45].

[68] Id.

[69] Id.

participants the opportunity to draw chips in exchange for a clean test twice a week.[70]

In the context of smoking cessation, research suggests cash-based incentives may be both particularly effective and preferable to other interventions. One study compared both group and individual cessation interventions and found that offering participants cash—a total of $800 if they quit for at least 6 months—was the most effective way to encourage quitting.[71] Other studies have shown similarly positive results,[72] and some researchers have suggested that Medicaid pay smokers who are willing to quit.[73]

Some cities in the United States have also implemented programs that pay young women to avoid teen pregnancy.[74] For example, a North Carolina program called "College Bound Sisters" paid women ages twelve to eighteen a dollar a day (paid as seven dollars per week) for every week they did not get pregnant.[75] The money was deposited into a fund and became collectable only when they enrolled in college.[76] Planned Parenthood in Denver, Colorado sponsored a similar program in the late 1980s.[77]

[70] Id.

[71] Scott D. Halpern et al., Randomized Trial of Four Financial-Incentive Programs for Smoking Cessation, 372 N. Eng. J. Med. 2108, 2108 (2015). Another intervention explored in the study was a deposit program in which participants would put up their own funds and earn them back if they successfully quit. Although the deposit was very effective for those who chose it, the cash incentive was more successful overall at reducing smoking, because significantly more participants opted for the cash intervention over the deposit. Id. at 2114.

[72] See, e.g., Kevin G. Volpp et al., A Randomized, Controlled Trial of Financial Incentives for Smoking Cessation, 360 New Eng. J. Med. 699, 707 (2009) (finding that a group who received financial incentives to refrain from smoking had "significantly higher" rates of "prolonged abstinence" than did a control group, who did not receive the same incentives).

[73] See, e.g., Jody Sindelar, Opinion, Should We Pay People to Stop Smoking?, CNN (Oct. 5, 2011), https://www.cnn.com/2011/10/05/opinion/sindelar-smoking-medicaid/index.html [https://perma.cc/C3Y6-39H8].

[74] Thaler & Sunstein, supra note 3, at 236.

[75] Joshua Rhett Miller, North Carolina Program Pays Girls a Dollar a Day Not to Get Pregnant, Fox News (June 25, 2009), https://www.foxnews.com/story/north-carolina-program-pays-girls-a-dollar-a-day-not-to-get-pregnant [https://perma.cc/L6JJ-7CVW]. The payment was contingent on attending a ninety-minute lesson each week, where the women learned about abstinence and contraception use. Id.

[76] Id.

[77] Dyan Zaslowsky, Denver Program Curbs Teen-Agers' Pregnancy, N.Y. Times, Jan. 16, 1989, at A8.

b. Environment

Another common context for incentive-based nudges is environmental protection. Although traditional regulation in the form of subsidies and penalties is also common in this area,[78] researchers have noted that behavioral biases underlie many environmental challenges, like addressing climate change.[79] For example, researchers have observed that individuals underinvest in energy-efficient appliances, even when there would be cost savings from purchasing them, because of their tendency to discount future benefits.[80] Recognizing that behavioral economics provides additional insights into how to encourage people to make environmentally friendly choices, a number of "green nudges"[81] have been developed in the past several decades.

As in the case of health-related nudges, not all green nudges involve incentives, and many incorporate other types of nudges like defaults, simplification, or appeals to social norms. For example, some utility companies may default customers into renewable energy sources while allowing them to opt out, thereby increasing the number of consumers who use green energy.[82] And as discussed above, letters appealing to social norms are common tools to reduce energy consumption.

In several other environmental contexts, researchers and governments have offered nudges that are incentives. Recognizing that individuals underinvest in energy-efficient technology despite substantial cost savings,[83] many utility producers offer free or subsidized products. For example, Duke Energy Company offers customers in some states free LED light bulbs, which burn more efficiently than standard bulbs and

[78] Economic Incentives, Environmental Protection Agency, https://www.epa.gov/environmental-economics/economic-incentives [https://perma.cc/UCT5-4JJB] (last visited Dec. 21, 2020) (explaining that market-based incentives, like taxes and subsidies, are "becoming increasingly popular as tools for addressing a wide range of environmental issues").

[79] Christian Schubert, Green Nudges: Do They Work? Are They Ethical?, 132 Ecological Econ. 329, 329 (2017).

[80] See Howard Kunreuther & Elke U. Weber, Aiding Decision Making to Reduce the Impacts of Climate Change, 37 J. Consumer Pol'y 397, 397–98 (2014).

[81] See, e.g., Schubert, supra note 79, at 330 (defining green nudges as "nudges that aim at promoting environmentally benign behavior").

[82] Id.

[83] See Hunt Allcott & Dmitry Taubinsky, Evaluating Behaviorally Motivated Policy: Experimental Evidence from the Lightbulb Market, 105 Am. Econ. Rev. 2501, 2501–02 (2015) (exploring the phenomenon and finding that moderate subsidies for energy-efficient lightbulbs may be effective in addressing this underinvestment).

reduce energy costs.[84] The company also offers substantial rebates on the purchase and installation of energy efficient appliances.[85] Customers that replace an old HVAC system with a more energy-efficient one can earn a $400 payment for installing a geothermal heat pump and an extra $50 for installing a smart thermostat.[86] Customers can also earn $250 for sealing their attics and an additional $100 for ductwork repair.[87]

Researchers in Japan experimented with a nudge approach to encourage homeowners to undertake home improvements that would mitigate future earthquake damage, a process known as seismic retrofitting.[88] Past experience in Japan showed that it is hard to motivate individuals to incur the costs of such home improvements, even if it is ultimately in their financial interest due to expected future harms.[89] To encourage seismic retrofitting in the study, survey respondents were presented with the option of a free warranty with their retrofitting that would cover the entire cost of repair if a retrofitted house were damaged in an earthquake.[90] The theory behind the nudge was that consumers generally overvalue warranties offered with products (e.g., a warranty offered for purchase with a new television), so a warranty might serve as a good motivation to undertake the seismic retrofitting improvements.[91] The study confirmed that, indeed, individuals were more willing to improve their home when nudged with a warranty offer.[92]

[84] Free LED Program, Duke Energy, https://www.duke-energy.com/home/products/free-leds [https://perma.cc/FY93-D5L5] (last visited June 19, 2019); see also Commercial Retrofit, Puget Sound Energy, https://www.pse.com/rebates/business-incentives/commercial-retrofit-grants [https://perma.cc/R578-FS72] (last visited July 5, 2019) (providing coverage for up to 70% of the cost for energy efficient upgrades).

[85] Smart $aver: Home Improvement Rebate Program, Duke Energy, https://www.duke-energy.com/home/products/smart-saver [https://perma.cc/GAT6-GC5L] (last visited June 19, 2019).

[86] HVAC Install, Duke Energy, https://www.duke-energy.com/home/products/smart-saver/hvac-install [https://perma.cc/BE7P-YTJQ] (last visited June 19, 2019).

[87] Insulate & Seal, Duke Energy, https://www.duke-energy.com/home/products/smart-saver/insulate-and-seal [https://perma.cc/RC5K-V89W] (last visited June 19, 2019).

[88] Toshio Fujimi & Hirokazu Tatano, Promoting Seismic Retrofit Implementation Through "Nudge": Using Warranty as a Driver, 33 Risk Analysis 1858, 1873 (2013).

[89] See id. at 1859–60.

[90] Id. at 1863.

[91] Id. at 1859.

[92] Id. at 1873.

6. Beyond Nudges: Behaviorally Based Subsidies

Imagine that the government offers individuals a cash payment of $1,000 to reward a desired behavior. Is that a nudge or a subsidy? In the case of incentives, it may be impossible to draw a line between what constitutes an immaterially small cash incentive (a nudge) and a true economic subsidy. But identifying a dollar threshold separating nudges and subsidies is not necessary for purposes of this discussion. Some payments are too large to technically qualify as "nudges," yet their effectiveness may still be explained by behavioral, rather than purely economic, considerations. This Article refers to such payments as "behaviorally based subsidies" ("BBS").

Consider again the example of the individual who faces a cost of $10,000 to install solar panels and values the improvement at only $8,000. If people always made economically rational decisions, then offering the individual a $3,000 tax credit should incentivize her to install the panels. Her total installation cost, after factoring in the credit, would be $7,000, while the benefit would be $8,000, resulting in a net gain of $1,000 from the transaction.

In reality, however, we know that individuals do not always behave rationally. Imagine that the individual is confronting the decision whether to install the panels in June of 2019. To do the work in the summer, she may have to pay for the panels by August. The tax credit would be claimed on her 2019 return, which she could not file until 2020. This scenario creates several psychological obstacles to installing the panels.

First, individuals are present-biased and tend to discount future payments.[93] This means that spending $10,000 now and receiving a $3000 credit next year might not "feel" like a net cost of $7000, but might instead be experienced as a $10,000 loss. Second, how the individual responds to the tax credit might depend on her overall tax payment position. If she is already owed a refund when she files her tax return, and the tax credit results in $3,000 of additional refunded money, she is more likely to experience the credit as a windfall.[94] On the other hand, if the $3,000 credit simply reduces the taxes she owes, the credit will be less salient, and she may value it less.[95]

[93] See supra note 62.
[94] See Kathleen DeLaney Thomas, The Modern Case for Withholding, 53 U.C. Davis L. Rev. 81, 124 (2019).
[95] See id. at 114.

As the example illustrates, there are many behavioral considerations when structuring incentives. Consumers may need to be paid upfront to be sufficiently motivated to change their behavior. Or in some contexts, consumers may respond better to cash than to other forms of incentives. In the case of the solar panels, an upfront cash grant may function as a BBS because an economically equivalent tax credit, paid months after the fact, may not be effective. In reality, a combination of both behavioral and economic considerations likely contributes to the effectiveness of many incentives.[96]

Turning to real-world examples, policymakers have increasingly recognized the need to structure traditional economic incentives according to behavioral preferences. Going back to the case of seismic retrofitting, where individuals are frequently unmotivated to improve their homes even when it will save them money, some governments have offered cash grants. Some cities in Japan have offered cash subsidies as high as 1.5 million yen[97] (nearly 14,000 U.S. dollars). In earthquake-prone regions of California, homeowners may apply for a cash grant of $3,000 to retrofit their homes to prevent future damage.[98] These grants are likely motivated by a combination of factors, including making it more affordable for individuals to improve their homes (economic subsidy) and providing individuals with an immediate, salient cash reward for doing so (behavioral).

The distinction between nudge and subsidy generally has no bearing on whether an incentive is taxable, as discussed further in Part II. Further, the obstacles posed by taxing incentives—deterring participation in programs with worthy policy goals, for example—will often exist regardless of whether the incentive is a nudge or a subsidy. Accordingly, the remainder of the Article discusses nudges and BBS on a collective basis.

II. TAX TREATMENT OF NUDGES

This Part overviews the basic federal income tax rules and then turns to the tax treatment of nudges and BBS.

---

[96] See Loewenstein & Chater, supra note 5, at 29–30.

[97] See Fujimi & Tatano, supra note 88, at 1872.

[98] Earthquake Brace + Bolt, https://www.earthquakebracebolt.com [https://perma.cc/5WPS-7X73] (last visited June 20, 2019).

A. Overview of Basic Income Tax Principles

1. Defining Income

The starting point for deciding whether a nudge is taxable is determining whether it constitutes "gross income" for federal income tax purposes.[99] Section 61 of the Internal Revenue Code ("Code") defines gross income as "all income from whatever source derived."[100] The definition sounds circular, but it creates a powerful default rule: anything that would be considered "income" from an economic perspective is income for tax purposes, regardless of where it came from. In other words, unless the Code specifically excludes it, any economic benefit is generally taxable.

The Supreme Court further refined the definition of income in *Commissioner v. Glenshaw Glass*, holding that the Code taxes "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[101] Thus, if a taxpayer has received something of value that makes them better off economically and there are no contingencies involved, they are generally subject to tax (unless an exception applies).

Several important principles flow from Code section 61 and *Glenshaw Glass*. First, source is generally irrelevant in determining whether something is income. Individuals are taxed on accessions to wealth whether they come from an employer, investment, a sale of property, a windfall like winning the lottery, or even money found on the street.[102]

Second, accessions to wealth of any *form* are taxable unless an exception applies, whether the benefit is cash, property, or services. This is why someone who wins a prize on a game show is taxable on the fair

[99] See, e.g., Cesarini v. United States, 296 F. Supp. 3, 4 (N.D. Ohio 1969) ("The starting point in determining whether an item is to be included in gross income is, of course, Section 61(a) of Title 26 U.S.C.").

[100] I.R.C. § 61(a). The statute goes on to provide a non-exclusive list of items of gross income, such as compensation for services, interest, rents, royalties, and dividends. Id.

[101] 348 U.S. 426, 431 (1955).

[102] See, e.g., *Cesarini*, 296 F. Supp. at 4 (holding that cash found in a used piano constituted taxable income under I.R.C. § 61(a)); Turner v. Comm'r, 13 T.C.M. 462, 463 (1954) (holding that cruise tickets received as a prize from a radio station constituted taxable income, with the only issue being valuation); see also Treas. Reg. § 1.61-14 (as amended in 1993) (expanding § 61(a) definition of gross income to include illegal gains and treasure troves, while clarifying that "[i]n addition to the items enumerated in section 61(a), there are many other kinds of gross income").

market value of the prize, even if they received no cash.[103] Similarly, if someone receives services in lieu of cash, they are taxed on the fair market value of the services. For example, if a plumber exchanges plumbing services with a dentist for dental services, both individuals are taxable on the benefit of services received.[104]

Accordingly, any nudge that provides an economic benefit to the recipient will be treated as taxable income unless an exception applies (discussed further below). This is the case regardless of whether or not the benefit is in the form of cash.

2. Exceptions

There are numerous exceptions to the general rule that all economic accessions to wealth are income for tax purposes. This Subsection discusses those exceptions that might be relevant to the taxation of nudges or BBS.[105]

a. Gifts

First, gifts and inheritances are not taxed as income.[106] Whether something is a gift for tax purposes depends on the intent of the person giving the purported gift. The test, created by the Supreme Court in *Commissioner v. Duberstein*, is whether the donor acted with "detached and disinterested generosity . . . out of affection, respect, admiration, charity, or like impulses."[107] Payments made out of "any moral or legal duty" or in anticipation of an economic benefit, on the other hand, do not constitute gifts.[108]

A classic gift would be a transfer between family members: if a grandmother sends her grandson $50 for his birthday, there are no income tax consequences, because her motivation is presumably generosity and affection. On the other hand, if a payment is made with an expectation of a quid pro quo, the transfer will not be treated as a gift. In *Duberstein*, the

103 See I.R.C. § 74 (a).

104 See Topic No. 420 Bartering Income, IRS, https://www.irs.gov/taxtopics/tc420 [https://perma.cc/4XMQ-EASH] (last visited June 20, 2019).

105 The discussion omits other exclusions not relevant for this purpose, such as the non-taxation of imputed income under the Code, the realization requirement (§ 1001), and statutory exclusions like § 101 (life insurance proceeds) and § 103 (interest on state and local bonds).

106 I.R.C. § 102.

107 363 U.S. 278, 285 (1960).

108 Id.

court held that a car described as a "present" was not a gift for tax purposes because the transferor, who was a business associate of the transferee, gave the car to preserve the business relationship.[109]

Incentive-based nudges or subsidies that come from the government generally will not qualify for gift treatment, because they are not motivated out of detached and disinterested generosity as required by *Duberstein*. For example, in Revenue Ruling 2003-12, the IRS ruled that government payments to assist disaster victims with medical, transportation, and housing expenses were not gifts, though they qualified for exclusion under other rules.[110] Similarly, in Revenue Ruling 2005-46, government disaster relief payments were not gifts because "the government's intent in making the payments proceeds from a government's duty to relieve the hardship caused by the disaster."[111] Because the IRS considers government payments to stem from a moral or legal duty, rather than generosity, affection, or the like as required by *Duberstein*, those payments generally will not receive gift treatment.

Payments from employers also do not satisfy the detached and disinterested generosity standard.[112] Congress has codified this in Code section 102(c), which prohibits employer payments from receiving gift treatment under any circumstance. Thus, even if an employer calls a bonus or noncash benefit a "gift," the Code taxes it as compensation.[113] Accordingly, nudges like wellness program incentives coming from employers will never receive gift treatment.

There is one scenario where nudges and subsidies are likely to be excluded from the recipient's income as a gift, and that is when the benefit comes from a charitable organization. In the same revenue ruling in which the IRS found government payments to assist disaster victims are not gifts, it ruled that those payments *are* gifts when made by a charitable organization.[114] When the payer is a charity organized to assist disaster victims, the IRS ruled, grants are made out of detached and disinterested

[109] Id. at 280, 291–92 (The transfer was "at bottom a recompense for Duberstein's past services, or an inducement for him to be of further service in the future.").

[110] Specifically, Code section 139 and the general welfare doctrine, both of which are discussed below. Rev. Rul. 2003-12, 2003-1 C.B. 283–84.

[111] Rev. Rul. 2005-46, 2005-2 C.B. 120.

[112] See, e.g., Rev. Rul. 2003-12, supra note 110, at 283.

[113] The exception is that certain employee achievement awards are excludable under I.R.C§ 74(c) (2018).

[114] Rev. Rul. 2003-12, supra note 110, at 284–85.

generosity, rather than out of moral or legal duty.[115] The IRS has similarly ruled that payments to individuals from charities are gifts in many other contexts, including matching funds deposited into adult savings accounts,[116] payments to honor military pilots who have lost their lives in the line of duty,[117] and payments to foreign nongovernment organizations to assist with education.[118]

Applying these rules to nudges, consider the case of paying cash to drug addicts to incentivize them to stay clean. If a charitable nonprofit that was organized specifically to help reduce addiction made the cash payments, those payments would likely be treated as gifts and excluded from income under section 102. However, similarly structured payments from the government would not receive such treatment and would be taxable unless another exclusion applies.

b. Fringe Benefits

The Code also exempts certain fringe benefits paid by employers to their employees from income.[119] The term "fringe benefits" generally refers to noncash benefits an employer provides as compensation, such as health insurance or free food.[120] Historically, these benefits were treated as income for tax purposes, yet the IRS frequently did not enforce the rules in this area.[121]

---

[115] Id. at 283–84.

[116] Rev. Rul. 99-44, 1999-44 I.R.B. 549–50. The matching contributions were gifts even though the savings accounts were established pursuant to a federal government program, which was administered by the charitable organization.

[117] See I.R.S. Priv. Ltr. Rul. 200442023 (Oct. 15, 2004).

[118] I.R.S. Priv. Ltr. Rul. 200529004 (July 22, 2005). Although payments from charities to individuals are likely to receive gift treatment in most situations, the *Duberstein* standard must still be satisfied for the gift exclusion to apply. For example, the IRS has stated in informal guidance that if a charity makes a payment to a for-profit business, "[t]he IRS will evaluate whether . . . . the payment was made out of a moral or legal obligation, an anticipated economic benefit or in return for services . . . ." Internal Revenue Service, Disaster Relief20, https://www.irs.gov/pub/irs-pdf/p3833.pdf [https://perma.cc/CQ2W-R83D]. Generally, payments made to individuals that are part of a "charitable class" (i.e., "large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance") should qualify for gift treatment. Id. at 9. I am grateful to Ellen Aprill for bringing this limitation to my attention.

[119] See, e.g., I.R.C. § 132.

[120] See Jay A. Soled & Kathleen DeLaney Thomas, Revisiting the Taxation of Fringe Benefits, 91 Wash. L. Rev. 761, 770 (2016).

[121] See id. at 766–68.

As a concession to what was already a widespread practice, Congress enacted Code section 132 in 1984, which enumerates specific fringe benefits that are excluded from gross income.[122] The listed exclusions include "de minimis fringe[s]," which are benefits that are too small to account for administratively (like free coffee); as well as "working condition fringe[s]," the provision of free property or services that would be deductible if purchased directly by the taxpayer (like airfare for a business trip).[123] Congress's intent was clear that, unless enumerated in section 132 or exempted elsewhere in the Code, fringe benefits continue to be taxable.[124] Several other Code sections exempt specific fringe benefits. For example, section 106 excludes the benefits of employer-provided health insurance, and section 129 excludes certain dependent care assistance programs.

In contrast to gifts, intent generally does not matter when it comes to payments from employers to employees—payments are generally treated as compensation unless excluded as fringe benefits.[125] Code section 102(c) prevents gift treatment even if an employer labels a payment as a "gift" (and even if the employer's motive is generosity). In the context of nudges, then, whether an incentive paid to an employee is taxable will depend on whether it specifically qualifies for exclusion under section 132 or another Code provision. For example, if an employer occasionally provides free fruit to employees to encourage healthier eating, that is likely a de minimis fringe benefit, which is excludable under section 132.[126] However, unless a nudge or BBS fits into a particular statutory exclusion, benefits given to employees by their employer will generally be taxed as compensation.[127]

[122] Id. at 769–70.

[123] I.R.C. § 132(d), (e).

[124] See Soled & Thomas, supra note 120, at 770.

[125] However, if an employee is a shareholder or owner of the employer, payments made to employees may be treated as dividends rather than as compensation. See, e.g., Andrew W. Stumpff, The Reasonable Compensation Rule, 19 Va. Tax. Rev. 371, 377 (1999).

[126] I.R.C. § 132(a)(4), (e).

[127] In a similar context but *outside* the employment setting, a court allowed for exclusion of an all-expenses-paid business trip to Germany because the payment was made for the convenience of the payer, rather than for the recipient's benefit. United States v. Gotcher, 401 F.2d 118, 119, 122 (5th Cir. 1968). Neither courts nor the IRS have explicitly extended the line of reasoning in *Gotcher* to other settings, particularly to non-business settings. However, the line of reasoning in the case could arguably apply to exclude many nudges from income. The argument would be that payments made primarily for the payer's benefit (e.g., a government grant program) are not taxable income to the payee. Thanks to Ted Seto for this observation.

c. Purchase Price Adjustments

Another income exclusion that may be relevant to some nudges is the purchase price adjustment doctrine. Though not explicitly provided for in the Code, both courts and the IRS have excluded certain economic benefits from income if they can be characterized as an adjustment to the purchase price between a buyer and a seller.[128] Imagine, for example, that a taxpayer purchased a $20,000 car and later received a $1,000 manufacturer's rebate. Rather than taxing the buyer on $1,000 of income at the time of the rebate, the IRS treats the transaction as an adjustment to the original purchase price: the taxpayer is simply treated as having paid $19,000 for the car, and is not taxed on the rebate.[129]

To qualify as a purchase price adjustment, the benefit provided to the taxpayer generally must come from the party who sold the taxpayer goods or services. In rare cases, courts have allowed purchase price adjustment treatment for a benefit provided by a third party as long as the overall effect of the arrangement is a purchase price reduction on a sale to the taxpayer. For example, in *Freedom Newspapers, Inc. v. Commissioner*, a cash payment made to a newspaper buyer by a third-party broker was not taxable because the purpose of the cash payment was to induce the buyer to make the purchase, and the overall effect of the transaction was a reduction in the price paid by the buyer.[130]

The purchase price adjustment doctrine excludes many common benefits provided by retailers, like bonus rewards programs, coupons, and other discounts. However, if the benefit cannot be characterized as a reduction in the price for goods or services *paid* by the taxpayer, the benefit is generally taxable. For example, when Citibank rewarded customers with airline miles for opening checking accounts, the Tax

[128] See, e.g., Pittsburgh Milk Co. v. Comm'r, 26 T.C. 707, 717 (1956); Freedom Newspapers, Inc. v. Comm'r, 36 T.C.M. (CCH) 1755, 1758–59 (1977); Rev. Rul. 76-96, 1976-1 C.B. 23.

[129] See Rev. Rul. 76-96, 1976-1 C.B. 23. The taxpayer must reduce his basis in the property purchased by the amount of the rebate, resulting in a basis of $19,000 in this example.

[130] Freedom Newspapers, 36 T.C.M. (CCH) at 1756–57. But see I.R.S. Priv. Ltr. Rul. 201004005 (Jan. 29, 2010) (ruling that grants paid by a third party were not excludable from income, even when the net effect was to reduce the buyer's cost on a purchase transaction). In the private ruling, the IRS distinguished payments involving broker commissions, which are dependent upon the sales transactions, from third-party grants that are independent of the transaction. Id.

Court held the value of the miles was taxable income.[131] In the case, the taxpayer did not have to pay a fee for opening the account, so the miles could not be characterized as a reduction in that fee. Instead, the court likened the free miles to interest earned on a deposit.[132] In contrast, airline miles or "cash back" rewards earned for the use of a credit card should be excludable under the purchase price doctrine, because they are more akin to rebates of credit card fees owed by the cardholder.[133]

A nudge that provides value to a customer who is paying for goods or services may qualify as a purchase price adjustment, as discussed further below. To qualify, however, it is likely that the benefit must be provided directly by the seller of goods and services, and not by a third party.

d. The General Welfare Doctrine

Payments from a federal, state, or local government are also taxable to individuals unless an exception applies.[134] For example, the Ninth Circuit held that dividend payments made to each Alaskan citizen from the Alaska Permanent Fund constituted income for federal income tax purposes.[135] The court rejected gift treatment in that case because the clear legislative intent behind the dividend payments was to encourage people

[131] The taxpayer received "Thank You Points" that were redeemable for airline miles. Shankar v. Comm'r, 143 T.C. 140, 148 (2014). The court also noted that the miles were not earned during business travel, which the IRS has singled out for non-enforcement in Announcement 2002-18, 2002-1 C.B. 621.

[132] *Shankar*, 143 T.C. at 148.

[133] See I.R.S. Priv. Ltr. Rul. 201027015, at 3 (July 9, 2010) (ruling that cash-back rebates are excluded from gross income as purchase price reductions).

[134] For taxpayers that are corporations, Code § 118 historically exempted "contributions to capital," which covered many government grants to corporations. However, section 118 was amended in 2017 and currently does not exempt contributions to capital made by "any governmental entity." I.R.C. § 118(b). Regardless, this Article is concerned with incentives provided to individual taxpayers, not corporations.

There are other special exclusions applicable to businesses not discussed in detail here. For example, Code § 48(d)(3) excludes grants made to developers and producers of renewable energy, pursuant to the American Recovery and Reinvestment Act of 2009.

[135] Greisen v. United States, 831 F.2d 916, 918 (9th Cir. 1987). The Alaska Permanent Fund is funded by the state's mineral royalties; it distributes earnings in the form of dividends to each resident of the state on an annual basis. Id. at 916–17; see also About Us, Alaska Department of Revenue: Permanent Fund Dividend Division, https://pfd.alaska.gov/Division-Info/About-Us [https://perma.cc/QHG2-M67C] (last visited July 1, 2019) (explaining the Alaska Permanent Fund eligibility and dividend calculation functions).

to remain residents of Alaska, rather than detached and disinterested generosity.[136]

Courts have recognized an exception to the taxability of government grants, referred to as the "general welfare exception."[137] The doctrine originated with the IRS, which has ruled that government payments made under "social benefit programs for the promotion of the general welfare" are not included in the recipient's gross income.[138] For example, welfare payments made under programs like Temporary Assistance for Needy Families ("TANF") are generally excluded from income under the doctrine because TANF is a social benefit program that promotes general welfare.[139]

To be excluded from income under the general welfare doctrine, a government grant must: (1) be made for the promotion of general welfare, which means it must be based on need; and (2) not be paid as compensation for services.[140] Government payments made to assist natural disaster victims[141] or crime victims[142] qualify as need-based grants for this purpose, as do home rehabilitation grants paid to low-income homeowners.[143]

Government grants that are not need-based do not qualify for the general welfare exception and are generally taxable unless another exception applies. For example, in *Bailey v. Commissioner*, the Tax Court

[136] *Greisen*, 831 F.2d at 919–20 ("According to the statement of purpose, the 1980 Act was intended: (1) to allow equitable distribution of part of the state's wealth to Alaskans; (2) to encourage people to remain Alaska residents; and (3) to encourage awareness and interest in the management of the fund.").

[137] See, e.g., Graff v. Comm'r, 673 F.2d 784, 785 (5th Cir. 1982). For a comprehensive discussion of the doctrine, see Theodore P. Seto & Sande L. Buhai, Tax and Disability: Ability to Pay and the Taxation of Difference, 154 U. Pa. L. Rev. 1053, 1106–14 (2006); see generally Robert W. Wood & Richard C. Morris, The General Welfare Exception to Gross Income, 109 Tax Notes 203, 204–08 (2005) (describing the development of the General Welfare Exception and the prongs of the test determining whether a payment qualifies).

[138] Rev. Rul. 2005-46, 2005-2 C.B. 120; see also Rev. Rul. 74-205, 1974-1 C.B. 20 (ruling that housing payments to displaced families qualified under the general welfare exception, and were not includible in gross incomes of the recipients); Rev. Rul. 98-19, 1998-1 C.B. 840 (ruling that a relocation payment made to an individual moving from a flood-damaged residence qualified for the general welfare exception).

[139] I.R.S. Notice 99-3, 1999-1 C.B. 271, 272.

[140] Rev. Rul. 2005-46, supra note 138.

[141] Rev. Rul. 2003-12, 2003-1 C.B. 283; Rev. Rul. 76-144, 1976-1 C.B. 17. However, the IRS has ruled that payments to *businesses* do not qualify for the doctrine, because the need must be "individual or family" based. See Rev. Rul. 2005-46, supra note 138.

[142] Rev. Rul. 74-74, 1974-1 C.B. 18.

[143] Rev. Rul. 76-395, 1976-2 C.B. 16.

held that a local government grant paid to the taxpayer to improve the façade of his building did not qualify for the general welfare exception.[144] Because recipients qualified for the grant simply by owning properties in specific areas, the court found the grant was not based on "need."[145]

Although some nudges and BBS come in the form of government grants, to qualify for exclusion under the general welfare doctrine, they must be need-based, which generally means either financial hardship or that the recipient is being compensated for a crime or natural disaster. Payments made by a local government to improve the health of its citizens, for example, would likely fail to qualify under this doctrine.

e. Qualified Disaster Mitigation Payments

When it comes to natural disasters, the general welfare doctrine exempts from income government payments made to assist disaster victims. Additionally, Code section 139(a) excludes from income government relief payments made to victims of federally declared disasters.[146] But what if a government provides grants to mitigate the damage of potential disasters before they happen? In narrowly defined circumstances, those payments are also exempt from tax.

Specifically, Code section 139(g) excludes "qualified disaster mitigation payment[s]" from gross income. To qualify under the section, a payment must be made to a property owner for "hazard mitigation," pursuant to either the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act.[147] In other words, mitigation payments made through one of these two specific, federally authorized programs are exempt under the statute, but payments pursuant to a state or local mitigation program will not qualify for the exemption. Thus, nudges or BBS that are designed to mitigate disasters will generally not qualify for exclusion under section 139(g), unless the payments are made pursuant to the specified federal programs.

[144] 88 T.C. 1293, 1301 (1987), acq. 1989-2 C.B. 1. The court excluded the grant from income on other grounds, however, finding that the taxpayer "lacked complete dominion" over the funds, which were paid directly to the contractor who did the work.

[145] Id. (noting that the only requirements to receive the grant "were ownership of the property and compliance with the building code").

[146] The exclusion applies to "qualified disaster[s]," which also includes events involving terrorism or common carrier accidents. See I.R.C. § 139(c). For a critique of limiting the exclusion to qualified disasters only, see Ellen P. Aprill & Richard Schmalbeck, Post-Disaster Tax Legislation: A Series of Unfortunate Events, 56 Duke L.J. 51, 95 (2006).

[147] I.R.C. § 139(g).

B. Non-Taxable Nudges

As discussed above, the starting point for taxation under the Code is income, which is a clearly realized accession to wealth. Accordingly, those nudges described in Section I.B that do not represent economic benefits to the recipient have no tax implications. The nontaxable categories include defaults, information, simplification, and appeals to social norms. Examples of such nudges are automatic enrollment into organ donation programs, simplification of instructions or other disclosures, text message reminders, salient warnings on cigarettes, and letters reminding taxpayers that others in their community are compliant.

What about defaults, reminders, or other nudges that ultimately have financial consequences? Consider, for example, automatic enrollment into savings programs. Imagine a typical worker who is prone to status quo bias, and would not go through the trouble of enrolling in a savings program at the start of his employment. If the worker did not otherwise have any savings, his investment income would be zero.

Now assume that the worker is automatically enrolled into a savings plan when he starts his job, which sets aside 3% of his salary into a 401(k) plan. In this scenario, he has investment income. Does this mean that the nudge provided a taxable benefit? Under the tax law, the answer is clearly no. Although the worker has earned income in the nudge scenario, default enrollment itself is not a source of income. Rather, the income comes from the investment in the savings plan, which would be taxed according to the Code. In this example, Code section 401(k) would defer income on the earnings, but this is irrelevant to the analysis.[148] We could imagine a nudge that encouraged taxpayers to set aside money in a taxable savings account, for example, that earned interest or dividend income. The earnings would be taxed under Code section 61 as investment income, but the nudge itself would not be taxable.[149]

In sum, some nudges, like defaults, information, or reminders, may encourage the taxpayer to enter into taxable transactions. But the nudges themselves are not taxable because it is not the behavioral intervention that gives rise to the income, but rather the transaction that the nudge was designed to encourage.

[148] I.R.C. § 401(k).
[149] I.R.C. § 61.

C. Taxable Nudges and Behaviorally Based Subsidies

In contrast to interventions like defaults or reminders, nudges that provide incentives, as well as any BBS, are accessions to wealth that generally constitute economic income. As such, these incentives are taxable unless specifically excluded by the Code or a judicial doctrine. The following section discusses the tax consequences of the incentive-based nudges discussed above in Section I.B., as well as BBS.

1. Workplace Wellness Programs

Benefits offered by employers through workplace wellness programs are generally taxable as compensation as a default matter. However, there are several statutory exclusions that are relevant in this context. First, wellness rewards will be excluded from income if they qualify as de minimis fringe benefits under Code section 132. De minimis fringe benefits include "any property or service the value of which is . . . so small as to make accounting for it unreasonable or administratively impracticable."[150]

Second, Code section 106 excludes employer-provided health insurance from an employee's income.[151] The section 106 exclusion also applies to insurance premiums that are deducted (pretax) from an employee's salary and paid by the employer on the employee's behalf.[152] Finally, under Code section 105, amounts paid to an employee through an employer-provided health plan to reimburse the employee for medical expenses are excluded from income.[153]

To start with the easiest cases, cash or cash-equivalent rewards in any amount are clearly taxable.[154] For example, if a wellness program offers a cash reward, or gift certificates in a specific dollar denomination, for losing weight or hitting other fitness goals, those benefits are taxable as compensation under Code section 61.[155] A gift certificate for $100 to a local restaurant would be taxed in the same manner as if the person

[150] I.R.C. § 132(e).

[151] I.R.C. § 106(a).

[152] Rev. Rul. 2002-3, 2002-1 C.B. 316 ("Under §106(a), an employee may exclude premiums for accident or health insurance coverage that are paid by an employer.").

[153] I.R.C. § 105(b).

[154] See, e.g., Office of Chief Counsel Internal Revenue Service Memorandum 201622031, at 1 (Apr. 14, 2016) [hereinafter "IRS Memo 201622031"].

[155] I.R.C. § 61.

received $100 in cash, regardless of whether or not the gift certificate was redeemed.[156]

It should be noted that even very small amounts of cash or cash equivalents are never treated as de minimis fringe benefits under Code section 132(e). This is because, to qualify as de minimis, it must be unreasonable or administratively impracticable to value the benefit.[157] Cash and gift certificates are never difficult to value, and thus are taxable compensation to employees, no matter how small.[158] Additionally, cash rewards and gift certificates will not qualify for exclusion under Code section 105 because they are not reimbursements for medical expenses.

Other common wellness program rewards are not cash equivalents, but rather are token items, like t-shirts, coffee mugs, or tote bags. In those cases, the rewards likely would qualify for exclusion from income as de minimis fringe benefits under Code section 132(e). Although the regulations do not specifically address these items, they are analogous to other de minimis fringe benefits listed in the regulation examples, such as "birthday or holiday gifts of property (not cash) with a low fair market value" and "flowers, fruit, books, or similar property provided to employees under special circumstances."[159] Furthermore, in informal guidance, the IRS has stated that a token reward like a t-shirt received under a wellness program constitutes a de minimis fringe.[160]

Wellness program gifts that are not token items, however, might cross the line into taxable territory. IRS guidance generally requires token awards to have a low fair market value to qualify as de minimis, although they do not specify where to draw the line in dollars.[161] For example, occasional sporting tickets are a de minimis fringe benefit under the regulations but season tickets are not.[162] It follows that a generous reward given as part of a wellness program would likely be taxable. For example, if an employer awarded a new car to the employee that achieved the highest level of a fitness goal, the fair market value of the car would clearly be taxable income.

[156] Treas. Reg. § 1.132-6(c) (as amended in 1992).
[157] I.R.C. § 132(e).
[158] Treas. Reg. § 1.132-6(c) (as amended in 1992). The exception to this rule is cash for occasional overtime meals or transportation fare can be excluded as de minimis. See Treas. Reg. § 132-6(d)(2) (as amended in 1992).
[159] Treas. Reg. § 1.132-6(e)(1) (as amended in 1992) ("Benefits excludable from income").
[160] IRS Memo 201622031 at 4.
[161] Id. at 4.
[162] See Treas. Reg. § 1.132-6(e)(1)–(2) (as amended in 1992).

Other common wellness program incentives are in the form of services rather than property, such as free biometric screenings, seminars, gym memberships, health coaching, or smoking cessation programs.[163] In general, the receipt of services by employees constitutes taxable income in the amount of the fair market value of the services.[164] However, services received in connection with wellness programs may be excludable if either section 132 or section 105 applies.

First, section 132(e) provides that an excludable de minimis fringe benefit may take the form of services, so services of a sufficiently small value should qualify. The frequency of the service is also relevant to the determination of whether it is de minimis.[165] The regulations point to free phone service to make local telephone calls as an example of a de minimis fringe benefit, while use of an employer-owned vehicle to commute more than once a month is not de minimis.[166]

Second, if the services offered by the wellness program constitute medical care, then they should be excluded from the employee's income under Code section 105(b), even if the value of the services is not de minimis.[167] Since section 105(b) excludes employer reimbursements for medical care from income, the IRS treats providing access to free medical services as similarly excludable.[168]

Health screenings and some health-related services, like smoking cessation programs, constitute medical care under the tax law and are thus excludable from income under section 105(b) when offered as part of a wellness program.[169] Other services like health coaching and weight loss programs may not qualify as medical care and would therefore likely be taxable unless they qualify as de minimis fringe benefits.[170]

[163] See supra notes 51–53 and accompanying text.

[164] See Treas. Reg. § 1.61-2(d)(1) (as amended in 2003).

[165] I.R.C. § 132(e)(1).

[166] Treas. Reg. § 1.132-6(e)(1)–(2) (as amended in 1992).

[167] See IRS Memo 201622031 at 2, 4–5. "Medical care" is defined in section 105(b) by reference to section 213(d) of the Code, which provides that medical care includes amounts paid "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." I.R.C. § 213(d)(1)(A).

[168] See IRS Memo 201622031 at 2, 5.

[169] See id. For examples of medical care under section 213, including smoking cessation programs, see IRS Publication 502, Medical and Dental Expenses, https://www.irs.gov/pub/irs-pdf/p502.pdf [https://perma.cc/3GGF-RMV3] (last visited Mar. 10, 2021).

[170] Medical expenses include payments for a weight-loss program "for a specific disease diagnosed by a physician," so it is unlikely that a weight-loss program would qualify in the absence of a diagnosis. See IRS Publication 502, supra note 169.

Occasional seminars and educational programs, which are likely offered infrequently, probably qualify as de minimis fringe benefits and should be excluded from employees' income.[171] Other services, however, like free health coaching and Weight Watchers meetings, may be too valuable and frequent to constitute de minimis fringe benefits. Provision of these services should probably be taxed to employees at their fair market value, although it is unclear if employers actually report them as income.[172]

Private gym memberships are specifically included in the section 132 regulations as an example of a benefit that is too valuable to be de minimis, and the regulations note that it does not matter if the employee actually uses the membership or not.[173] Gym memberships also do not constitute medical expenses and will not qualify for exclusion under section 105(b). Thus, free gym or health club memberships offered by wellness programs will be taxable to the employees at their fair market value.[174]

Discounts on gym memberships (or similar, non-medical services) should also constitute taxable income to employees in the amount of the discount. Although section 132 does provide that "qualified employee discount[s]" are excludable fringe benefits,[175] the discount offered must be related to the employer's line of business.[176] For example, a clothing store can offer its employees a tax-free discount on clothing, but cannot offer tax-free discounts on unrelated products or services.[177]

Another common wellness program benefit is to offer employees: (1) a reduction in health insurance premiums owed; or (2) reimbursement of premiums paid, in exchange for hitting certain health targets.[178] Reductions in health insurance premiums offered for wellness program participation should be tax-free to employees. If the health insurance company lowers its rates and that rate reduction is passed on to the

[171] See Treas. Reg. § 1.132-6(e)(1) (as amended in 1992) (citing examples of "occasional" events, such as sports games or cocktail parties, as ones that qualify as de minimis).

[172] In an analogous context, it appears many service-type benefits offered by Silicon Valley companies, such as free dry cleaning, haircuts, or yoga classes, are likely not reported as taxable by those employers. See Soled & Thomas, supra note 120, at 779–86.

[173] Treas. Reg. § 1.132-6(e)(2) (as amended in 1992). However, onsite gyms operated by the employer qualify for exclusion. See I.R.C. § 132(j)(4).

[174] See IRS Memo 201622031 at 4–5.

[175] I.R.C. § 132(a)(2).

[176] I.R.C. § 132(c)(4).

[177] It follows that a private gym could offer discounted gym services to its own employees.

[178] See supra note 57 and accompanying text.

employee, the employee would not be taxed on the discount because it would constitute a purchase price adjustment.[179] If the insurance company does not lower its premiums and the discount instead comes from the employer assuming the excess cost on the employee's behalf, the reduction should still be excludable as employer-provided health insurance under section 106.[180]

Reimbursements of premiums, however, do not qualify for exclusion under section 106 and are taxable to employees.[181] A common arrangement is for employees to make pretax contributions to a wellness plan as part of their employer sponsored health plan, and then to be reimbursed for a portion of those contributions through wellness program rewards, such as receiving a cash prize for taking a health screening test.[182] Because employees are initially allowed to pay those premiums pretax under section 106, the IRS has ruled that employees may not then receive a cash reimbursement of those funds tax-free.[183]

In sum, the tax consequences of employer wellness program rewards vary depending on the benefit provided. Free healthcare services and token prizes are excludable as either medical care or de minimis fringe benefits. However, cash prizes, gift certificates, gym memberships, and rewards of significant value generally will be taxable to employees, as will reimbursements of insurance premiums.

2. Non-Employer Health Nudges

The exclusions provided by section 132 (fringe benefits), section 106 (employer-provided health insurance), and section 105 (employer reimbursement of medical expenses) are limited to the employment context. Therefore, if someone other than an employer provides nudges in the form of health-related incentives, those awards are taxable unless another exclusion applies.

In the case of incentives provided by private health insurance providers, the purchase price adjustment doctrine likely applies. For example, an insurance company might decide to reward policyholders for quitting smoking, since smoking increases healthcare costs. If the insurance company offers cash in exchange for a policyholder completing

[179] See supra note 128 and accompanying text.
[180] See supra note 152.
[181] See IRS Memo 201622031 at 5.
[182] See id. at 2–5.
[183] See Rev. Rul. 2002-3, supra note 152.

a smoking cessation program, the cash award would likely be considered a rebate of the premiums paid by the policyholder. As such, the rebate would be a non-taxable purchase price adjustment.

This analysis likely does not hold for recipients of public insurance like Medicaid, however. If Medicaid provided cash rewards for smoking cessation, as proposed by some researchers,[184] the reward could not be characterized as a nontaxable rebate because the recipient would not have directly purchased the insurance services to begin with. In that case, the incentives would be treated the same as any government-provided health incentive.

How are health incentives treated when they do not come from employers or private health insurers? Consider programs like the former "Dollar a Day" paid to teens to not get pregnant,[185] or a government program that awards gift certificates or cash to drug addicts who stay clean.[186] There does not appear to be any statutory exception or judicial doctrine that would exclude them from income. Even if the payments come directly from government, the general welfare doctrine is unlikely to exempt them unless the program is considered to be need-based.[187]

One might argue that some narrowly tailored health incentive programs are need-based. For example, if a local government gives cash to addicts who get clean, the "need" might be described as drug addiction. Although this argument is not without merit, there is no precedent supporting this approach. To date, the general welfare exception has only been applied by the IRS in cases of economic hardship or to victims of crime or natural disasters.[188]

Some health-related nudges provide benefits in connection with programs that would be tax deductible if paid for directly by the recipient. For example, if an individual pays out of pocket for an inpatient drug rehabilitation program, the payment would qualify as a deductible medical expense under Code section 213.[189] This raises the question of whether individuals should be taxed on the receipt of incentives that would be tax deductible if they paid for them directly. One could argue

[184] See supra note 73 and accompanying text.

[185] See supra notes 75–77 and accompanying text.

[186] See supra notes 67–70 and accompanying text; 75–77 and accompanying text.

[187] See supra note 140 and accompanying text.

[188] See supra notes 141–43 and accompanying text.

[189] See IRS Publication 502, supra note 169. However, the deduction is only available to itemizers (those who do not claim the standard deduction) and is limited to the excess of 10% of the individual's adjusted gross income. I.R.C. § 213(a).

that since an individual is not taxed on income that he spends on medical care directly (because those amounts are deductible), he similarly should not be taxed when the same medical care services are purchased by a third party.

In two analogous situations, payment of expenses that would be deductible as medical expenses if paid by the recipient are excluded when a third party pays them. One is the scenario contemplated by Code section 105(b), which excludes reimbursements by employers of employee medical expenses.[190] The other is Code section 104, which excludes, from income, recoveries paid to victims of physical injury.[191] For example, if a person is injured in a car accident and is paid compensation for her physical injuries by the motorist at fault, she is not taxed on the recovery. If she had instead paid her own medical bills from the car accident and not recovered compensation, those expenses would theoretically be deductible under section 213 (although in practice, only if she claimed itemized deductions).

In the case of government programs that provide health incentives, such as a grant to attend a private drug rehab center, neither section 104 nor 105 applies. In those cases, the government is not an employer and the money is not received as compensation for a personal injury. Thus, the recipient is likely taxable on the benefit. The fact that Congress carved out the two exceptions in sections 104 and 105 supports the notion that, outside of those narrowly defined circumstances of employment or injury compensation, payments for medical care are income.[192]

In sum, although such benefits might not be reported in practice, the provision of free health incentives may be taxable even if they constitute medical care under the Code, if those incentives do not come from an employer or health insurance company. Incentives that take the form of cash, such as paying drug addicts to stay clean, present an even easier case for taxation than the provision of medical services.

3. Green Nudges

The taxability of environmental nudges depends largely on who is providing the incentive. As discussed above, one common green nudge is

[190] I.R.C. § 105(b).
[191] I.R.C. § 104(a).
[192] Another exception, which would be irrelevant in this circumstance, is section 102, which would exclude from income medical care paid for by family members or friends. See I.R.C. § 102(a).

for a utility company to provide incentives to its customers to use less energy. Those incentives may be property, like free light bulbs, or cash rebates on energy efficient appliances.[193]

Regardless of the form the incentive takes, if the benefit comes from a utility provider, the purchase price adjustment doctrine likely excludes the benefit from the customer's income. Consider, for example, a homeowner who receives a $200 cash reward from her electricity provider for installing insulation in her attic.[194] Assume this hypothetical homeowner pays $100 per month to the utility company, for a total cost of $1,200 per year for electricity. Rather than being taxed on the $200 cash reward, the homeowner should be able to treat the cash as a reduction in the cost of the utility service for that year. In other words, the homeowner's overall utility cost would be re-characterized as $1,000 ($1,200 annual cost less the $200 reward). This is consistent with the IRS's treatment of rebates in other contexts, like a manufacturer's rebate on the purchase of a car.[195]

The fact that the reward for installing insulation in the preceding example is structured differently than the car purchase rebate should not change the tax treatment. Both courts and the IRS have made clear that a purchase price adjustment can be a direct reduction of the purchase price (as in the case of a car rebate) or an indirect reduction of the purchase price.[196] In the utility company example, the reward for installing insulation is not structured as a credit against the customer's electricity bill. This is likely because a cash reward is more salient and appealing. However, the economic effect is identical: a $200 cash reward is no different than a monthly reduction in utility costs that amounts to $200. Either scenario is ultimately a reduction in the amount owed to the utility company from the customer, and the $200 benefit comes directly from the utility company in both instances. Thus, the purchase price reduction doctrine should apply to exclude these types of nudges from taxation.

Other green incentives come from governments rather than from energy providers. In those cases, incentives are likely to be taxable unless

[193] See supra notes 84–87 and accompanying text.
[194] See, e.g., supra note 87.
[195] See supra note 129 and accompanying text.
[196] For example, in *Freedom Newspapers v. Commissioner*, 36 T.C.M. (CCH) 1755 (1977), the Tax Court held that even a payment received by a third party broker several years after the original purchase "was sufficiently tied to the purchase that its characterization must be made by reference to the original transaction."

either of: 1) the general welfare doctrine or 2) Code section 139(g) applies. Recall that section 139(g) applies only in narrow situations: it excludes, from income, hazard mitigation grants that are paid pursuant to either the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act.[197] Any government mitigation assistance that is not payable under those programs will not qualify for exclusion under the Code.

That leaves the general welfare doctrine, which only excludes payments based on "need." In the context of natural disasters and other environmental harms, the doctrine creates an odd tax result. Payments from governments to help victims of disasters that have already occurred are clearly excludable under the doctrine.[198] But payments to mitigate harms from future disasters are not, because those grants are not considered to be need-based.

Consider the case of earthquake mitigation payments like those paid by California to residents in high risk areas to incentivize them to retrofit their homes.[199] In recent informal guidance, the IRS ruled the grants are taxable because they are not paid pursuant to the specific federal programs required by Code section 139(g), and they do not qualify for the general welfare exception.[200] In ruling that the general welfare doctrine does not apply, the IRS noted that: 1) the grants are not based on "individual or family need" because they are based on the location and physical characteristics of the recipient's home; and 2) the grants are not paid "to alleviate suffering and damage resulting from a disaster" but instead are paid "to mitigate the effects of future disasters."[201] In what appears to be a concession to the accuracy of this interpretation of federal law, California lawmakers have proposed federal tax legislation that would

[197] I.R.C. § 139(g).

[198] See supra note 141 and accompanying text.

[199] See supra note 98 and accompanying text.

[200] I.R.S. Priv. Ltr. Rul. 201816004 (Jan. 11, 2018). See also I.R.S. Priv. Ltr. Rul. 201815005 (Jan. 11, 2018) (describing similar facts).

One theory that the IRS did not appear to consider is the purchase price adjustment doctrine. See supra Subsection II.A.2. Arguably, a state grant paid to a state taxpayer could be considered a non-taxable adjustment to the amount of taxes owed to the state by the grant recipient. (This assumes the grant recipient earns enough income to owe state taxes in excess of the grant.) While it is hard to distinguish a state grant from a seller rebate on economic grounds, it appears neither courts nor the IRS have extended the purchase price adjustment doctrine to this context. I am grateful to Heather Field for this observation.

[201] I.R.S. Priv. Ltr. Rul. 201816004 (Jan 11. 2018).

specifically exclude the earthquake mitigation grants from gross income.[202]

4. Behaviorally Based Subsidies

Whether an incentive can fairly be described as a nudge or is better characterized as a subsidy has no bearing on its tax consequences. In the case of earthquake mitigation grants, for example, some of those payments are in the thousands of dollars and are more of a subsidy than a true nudge. Regardless, they are taxable income under current law. The same goes for other types of incentive payments that qualify as subsidies. The purchase price or general welfare doctrines may exempt them if the subsidy comes from a seller or is need-based. Otherwise, they are likely to be taxable, unless some other exception applies. Although the taxation of subsidies may have different normative implications, the question of taxability is not dependent on the size of the incentive.

III. POLICY IMPLICATIONS

Part II has revealed the disjointed state of the tax law when it comes to nudges. Nudges that come from private parties are often tax-exempt, while identical incentives that come from the government are taxable. This Part now turns to the policy implications of the tax treatment of nudges. It first considers whether, as a normative matter, it is desirable to tax nudges. After arguing that taxing nudges is likely to counteract their effectiveness, this Part then offers proposals for reform.

A. Should Nudges and BBS Be Taxed?

As discussed in Part II, many incentive-based nudges (and BBS) do not qualify for exemption from income under the current tax rules. This Section considers, from a normative perspective, whether such incentives *should* be treated as income for tax purposes. The Section first examines whether nudges are appropriately considered income for economic purposes. It then discusses two analogues—gifts and scholarships—and considers whether the justifications for including those transfers from income should be extended to nudges and BBS.

[202] See Earthquake Mitigation Incentive and Tax Parity Act of 2017, H.R. 1691, 115th Cong. (2017); Earthquake Mitigation Incentive and Tax Parity Act of 2017, S. 2104, 115th Cong. (2017).

1. Do Nudges Constitute Economic Income?

Since Code section 61 taxes income from any source (unless otherwise excluded), a useful starting point is to consider whether incentive-based nudges and BBS constitute economic income. Personal income for economic purposes is commonly defined as the sum of 1) the positive change in an individual's net wealth; plus 2) the amount of his consumption.[203] The intuition is that annual income necessarily comprises everything an individual saves and spends during the year.

From an economic perspective, incentive-based nudges and BBS are generally a positive change in wealth, regardless of whether they are received in cash or in-kind. Indeed, many tax scholars have noted that government transfers are clearly economic income for this reason, notwithstanding the fact that the tax law often exempts them.[204] Even need-based government transfers, which currently qualify for exclusion under the general welfare doctrine, constitute economic income because they increase the individual's wealth.[205]

If incentive-based nudges and BBS constitute economic income, the next question is whether there is any normative reason to depart from the default of including them in income for tax purposes. Indeed, for nearly a century, tax scholars have been debating whether all items of economic income should be included in the tax law's definition of income (i.e., the "tax base"), or whether some items should be considered outside the scope of taxable income.[206]

[203] See Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50 (1938); Robert Murray Haig, The Concept of Income–Economic and Legal Aspects, *in* The Federal Income Tax 1, 7 (Robert Murray Haig ed., 1921). The definition is commonly referred to as the Haig-Simons definition of income. See, e.g., John R. Brooks, The Definitions of Income, 71 Tax L. Rev. 253, 262 (2018); Boris I. Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 Harv. L. Rev. 925, 932 (1967). For a comprehensive discussion of the difficulty of defining income and a description of several other approaches, see generally Brooks, supra; see also Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 47 (1990) (describing the Haig-Simons definition vis-à-vis the general difficulty in defining income).

[204] See, e.g., Bittker, supra note 203, at 935; Jonathan Barry Forman, The Income Tax Treatment of Social Welfare Benefits, 26 U. Mich. J.L. Reform 785, 799 (1993).

[205] Bittker, supra note 203, at 935–37.

[206] The legal scholarship on this point is too voluminous to cite, but for some of the earliest work, see, e.g., id. at 932; R. A. Musgrave, In Defense of an Income Concept, 81 Harv. L. Rev. 44 (1967); Joseph A. Pechman, Comprehensive Income Taxation: A Comment, 81 Harv. L. Rev 63 (1967); Charles O. Galvin, More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR, 81 Harv. L. Rev. 1016 (1968). For a

2. Nudges as Exclusions from the Tax Base: The Gift Analogy

Scholars have argued that certain items, like gifts, should be excluded from the tax base even though they technically constitute economic income. If nudges and BBS can be analogized to gifts, then a similar argument may exist that they should be excluded.

The Code contains many "tax expenditures," i.e., special preference items that are part of the tax base but are not taxed because of some policy choice made by Congress.[207] Examples include the tax deduction for mortgage interest (which encourages homeownership) and tax deferral for individual retirement accounts (which encourages savings). [208]

While gifts also receive special treatment under the Tax Code, they are distinguishable from these other tax preferences because Code section 102 is not labeled by Congress as a tax expenditure.[209] Rather, gifts are simply treated as not part of the tax base.[210] This is indicative of a view that gifts, while perhaps constituting economic income as a technical matter, should not be taxed in the same manner as other accessions to wealth. In other words, there is a view that excluding gifts from income is a more accurate way to tax individuals, rather than a special tax preference.

Why should gifts be excluded from the tax base? As some scholars have pointed out, the exclusion for gifts is a sensible approach when the donor and donee are considered collectively.[211] From a purely economic standpoint, when a donor makes a gift, she has a decrease in wealth and should be given a tax deduction. At the same time, the donee has a

discussion of the debate over the use of a "comprehensive tax base," see Brooks, supra note 203, at 270–74.

[207] See, e.g., Dep't of Treasury, Office of Tax Analysis, Tax Expenditures (2017), https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2019.pdf [https://perma.cc/8UVR-9ZKJ] [hereinafter "Tax Expenditures].

[208] Id. at 9, 18.

[209] Although the tax-free receipt of a gift by the donee is not labeled as an expenditure, the carryover basis provided by section 1015 for appreciated gifts is considered a tax expenditure. See J. Comm. on Tax'n, Estimates of Federal Tax Expenditures for Fiscal Years 2018–2022, 26 (Oct. 4, 2018), https://www.jct.gov/publications/2018/jcx-81-18/ [https://perma.cc/33XY-P3EB] [hereinafter "JCT Tax Expenditures"].

[210] See Tax Expenditures, supra note 207, at 3 ("The normal tax baseline also excludes gifts between individuals from gross income.").

[211] See, e.g., Richard Schmalbeck, Gifts and the Income Tax—An Enduring Puzzle, 73 Law & Contemp. Probs. 63, 65 (2010) (arguing that "although it is intuitively appealing to regard value received by gift as an element of the income of the individual receiving it, it is completely *un*appealing to regard value received by gift as an increment to income in the aggregate").

corresponding increase in wealth and should recognize income. The net revenue effect in that scenario is zero, as the deduction offsets the income inclusion.[212] The approach taken by the Code, which is to deny a deduction to the donor while excluding income to the donee, effectively provides the same result, which is a net of zero.

If the economically correct treatment of gifts (deduction to the donor and income inclusion for the donee) produces the same result as the current approach under the Code (no deduction and no inclusion), it is sensible to adopt the approach that is easier to administer. The Tax Code does just that. Having neither party report the gift for income tax purposes is unquestionably simpler because it means the gift need not be valued.[213] Accordingly, Code section 102's exclusion can be seen as a justifiable approximation of the economically correct way to treat gifts.

Further, commentators have noted that gifts do not result in any net increase in income, but rather are just a transfer of income from one party to another.[214] This can be contrasted with a market transaction, in which one individual typically exchanges goods or services for payment. In the latter scenario, both individuals are better off, and overall economic wealth has increased, with each party receiving something new. In the gift scenario, arguably only the donee is better off while the donor has not received anything. Although scholars have debated this point, there is at least an argument that gifts are rightfully treated differently than market transactions for tax purposes.[215]

Although nudges and BBS do not constitute gifts for tax purposes,[216] there is perhaps an analogous argument that they should not be taxed. Consider the transfer of funds from a local government to an individual

[212] Id. This of course assumes that the donor and the donee have the same tax rate. In reality, donors likely have higher tax rates than donees, in which case the net effect would be revenue loss to the government. For example, if the donor had a 30% marginal tax rate and the donee had a 10% marginal tax rate, the donor's deduction for a $100 gift would be worth $30 (30% of $100), while the donee's tax liability would be $10 (10% of $100), resulting in a $20 revenue loss.

[213] For income tax purposes, the gift is a non-event and need not be reported. However, the gift may need to be valued and returns filed if the gift tax applies. Currently, transfers under $15,000 are exempt from the gift tax. See, e.g., Frequently Asked Questions on Gift Taxes, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes [https://perma.cc/23XD-GDZC] (last visited July 11, 2019).

[214] E.g., Schmalbeck, supra note 211, at 65.

[215] The counterargument is that the gift represents consumption purchased by the donor. For a discussion of this theory, see id. at 68–69.

[216] See supra Subsection II.A.2.

to retrofit her house against earthquakes. The government is tax-exempt and does not take a deduction on the transfer. Thus, allowing the recipient to exclude the grant results in a net of zero tax revenue rather than net revenue loss, just as in the gift scenario. At the same time, the government has not received goods or services in exchange for the transfers; this is not a market transaction.[217] One might argue that, as in the gift context, this is just a transfer of value from party A to party B that should not be taxed. The weakness in this argument is that every government transfer works this way (no deduction to the payer), yet the tax rules require taxation of some such transfers.[218]

What about transfers that do not come from the government? Recall that, in many of those cases, the tax law already provides exemptions under either the purchase price adjustment doctrine or the section 132 fringe benefit rules. Some incentives are not covered by those rules, however. Consider an employee wellness program that offers cash for meeting fitness milestones, a benefit that is clearly taxable.[219] In that case, the gift analogy is not apt. The employer will likely deduct the payment as compensation or a business expense,[220] so allowing the employee to exclude the payment would result in net revenue loss to the government. Further, to the extent that the payment is made in the employment context, it is arguably paid in connection with the employee's services. Although the employee has not necessarily performed extra services to receive the payment, the employer likely intends the payment to be either: 1) an incentive to remain employed to perform future services, and/or 2) a way of enhancing the employee's ability to perform services (by staying healthy). Either of those scenarios looks much more like a market transaction—one that gives rise to an increase in wealth for both the employee and employer.

Thus, while the gift analogy might support an argument that some types of nudges should not be taxed, particularly incentives paid by governments, it is not a good analogy for payments by private parties, especially if the payment is deductible.

[217] For a similar argument, see Charlotte Crane, Government Transfer Payments and Assistance: A Challenge for the Design of Broad-Based Taxes, 59 SMU L. Rev. 589, 611–12 (2006) (pointing out that government transfers do not create new value).

[218] See, e.g., supra notes 134–135 and accompanying text.

[219] See supra note 154 and accompanying text.

[220] Either way, the payment is deductible under Code section 162.

3. Nudges as Tax Expenditures: The Scholarship Analogy

Another useful analogy to nudges is that of scholarships. Unlike gifts, the exclusion for scholarships under Code section 117 is currently considered to be a tax expenditure.[221] However, some commentators have argued that scholarships should be excluded from the tax base for economic reasons, rather than as a preference.[222] Whether they are properly excluded from the tax base or treated as tax preferences, there is ample support for not taxing them.

Like gifts, scholarships are not deductible by the payer, because the payer of a scholarship is generally tax-exempt (typically an educational institution or another nonprofit). Thus, excluding scholarships from the recipient's income presents a net zero transaction, and not revenue loss, for the government. Also, like gifts, scholarships are generally not paid as compensation for services or property in a market transaction.[223] The recipient of the scholarship receives education at a reduced price but does not confer goods or services upon the payer.

However, compared to gifts, the case for excluding scholarships from the tax base is weaker. In the gift context, wealth is simply transferred from one party to another, with no net increase in overall wealth. But with scholarships, new value is being created and conferred. When an

[221] JCT Tax Expenditures, supra note 209, at 27. The characterization of an exclusion as an expenditure depends on how Congress defines the tax base, and this has changed over time. See, e.g., Julie Roin, Truth in Government: Beyond the Tax Expenditure Budget, 54 Hastings L.J. 603, 608–10 (2003) (providing an overview of the development of the federal tax expenditure budget).

The characterization of scholarships depends particularly on varying definitions of the tax base, and Treasury has noted that:

> From an economic point of view, scholarships and fellowships are either gifts not conditioned on the performance of services, or they are rebates of educational costs. Thus, under the baseline tax system of the reference law method, this exclusion is not a tax expenditure . . . . The exclusion, however, is considered a tax expenditure under the normal tax method, which includes gift-like transfers of Government funds in gross income (many scholarships are derived directly or indirectly from Government funding).

See Tax Expenditures, supra note 207 at 13.

[222] See, e.g., Joseph M. Dodge, Scholarships Under the Income Tax, 46 Tax Law. 697, 698–99 (1993) (examining arguments for excluding scholarships from the tax base and for making them a tax preference); Charlotte Crane, Scholarships and the Federal Income Tax Base, 28 Harv. J. on Legis. 63, 113 (1991) (same).

[223] The exclusion in section 117 only covers scholarships paid for tuition and related expenses. Although some scholarship funds are conditioned on the performance of services like teaching or research, those funds are explicitly excluded from section 117 and are taxable. I.R.C. § 117(c)(1).

individual receives a scholarship that allows her to attend college for free, for example, she is receiving valuable educational services, which likely exceed the value of the scholarship itself.[224] Regardless, some scholars have argued that education is a unique benefit that is particularly hard to value, which merits exclusion from the tax base.[225]

Further, to the extent scholarships reduce the price paid to attend an educational institution, they arguably can be viewed as a nontaxable purchase price adjustment.[226] Even if scholarship funds come from government sources or nonprofits, rather than from the educational institution itself, the purchase price reduction precedent still suggests exclusion is appropriate.[227] Recall that, in other cases, courts have allowed rebates to come from third parties, as long as the overall effect is to reduce the price paid by the taxpayer on a purchase transaction.[228] One scenario where the purchase price reduction doctrine might not apply is for full scholarships, where the student pays nothing to the educational institution. Arguably this is still a bargain purchase (with a purchase price of zero), but the relevant authorities generally involve taxpayers who are otherwise paying something in the transaction.

Finally, even if scholarships are not nontaxable purchase price adjustments, and should be considered part of the tax base, Congress has chosen as a policy matter to exclude them from income as a tax expenditure. The exclusion under Code section 117 is part of a larger tax preference scheme intended to promote higher education, which also includes tax preferences for educational savings accounts, tax credits for attending higher educational institutions, and charitable deductions for contributions to donations to educational institutions.[229]

On a basic level, one could describe a scholarship as a free benefit provided to people to encourage them to engage in desirable behavior—attending college. When viewed this way, scholarships look a lot like nudges or BBS. (They also likely function as true economic subsidies.) If

[224] The value of the educational benefit likely exceeds the cost of tuition because higher educational institutions receive substantial funding from other sources besides tuition, including government subsidies. See, e.g., Crane, supra note 222, at 71.

[225] See generally sources cited at note 222 (observing the difficulty of assessing educational value as justification for exempting academic scholarships from taxable income under the federal tax code).

[226] See supra note 221; see also Dodge, supra note 222, at 701–02.

[227] See Dodge, supra note 222, at 711.

[228] See Freedom Newspapers v. Commissioner, 36 T.C.M. (CCH) 1755, 1758–59 (1977).

[229] JCT Tax Expenditures, supra note 207, at 27–28.

scholarships are tax-exempt because we want to encourage people to attend college, one could argue that nudges should be exempt for the very same reason.

For incentive-based nudges that provide taxpayers with goods, services, or cash that must be spent on a designated purchase, the scholarship analogy provides strong support for non-taxation. Consider again the case of earthquake retrofit grants. Unlike a true cash gift, which would provide money with no strings attached, a retrofit grant must be applied towards the specified work on the home. (It may also be a reimbursement for such work.) The recipient receives a valuable benefit, but the benefit is necessarily converted into the desired outcome—in this case, a safer house. Such is also the case with tax-free tuition scholarships, which do not provide disposable funds but, rather, provide money solely to pay for education (and related expenses). The provision of free light bulbs, or cash to upgrade to energy-efficient appliances, also provides benefits that must be applied to produce desired outcomes.[230]

The same is not true of all cash-based nudges, however. Some such incentives pay taxpayers after they have engaged in desired behavior, and provide taxpayers with no-strings-attached funds. An example would be paying someone cash to quit smoking. Arguably this looks more like compensation and less like a scholarship.

In sum, many incentive-based nudges and BBS resemble tuition scholarships, which have a long and well-accepted history of exclusion from income tax. In cases like grants to mitigate future damage from natural disasters or to purchase energy-efficient property, the funds are directed at achieving a specific, desired policy goal. Although the taxpayer has experienced an economic accession to wealth, excluding the benefit from tax serves to promote that goal. Further, the benefit is distinguishable from unrestricted cash grants. Although this analogy is

[230] Because retrofit grants and similar payments *must* be applied towards the specified property improvements, they are better viewed as the provision of property, rather than as a receipt of cash by the taxpayer. There is precedent for this approach, although it is not the approach the IRS has taken specifically with retrofit grants. For example, in *Bailey v. Commissioner*, the taxpayer wasn't taxed on an urban renewal grant for his property because the grant went directly to the general contractor, and the court found the taxpayer never had sufficient control over the funds to warrant taxation. See 88 T.C. 1293, 1301 (1987), acq., 1989-2 C.B. 1.

Arguably, any time an individual receives an incentive-based nudge or BBS in the form of cash that must be spent on specified property or services, the taxability of such funds should be based on the ultimate purchase, rather than on the temporary receipt of cash.

persuasive for many nudges, it does not support non-taxation of cash compensation in other contexts, such as achieving health goals.

4. Bottom Line: Which Nudges Should Be Taxable?

Recall that, as a default matter, the Code taxes all income *regardless of source*. If the ideal tax base includes all economic income, the payer of such income should not be relevant to the determination of taxability.

In reality, the Code does not tax all income and makes a number of deviations from the economic definition. Many of those deviations can be justified based on administrability, such as the fact that the Code taxes only realized gains, rather than unrealized accessions in wealth.[231] With the exception of gifts, which some have argued are rightfully excluded from the tax base, the payer is generally not relevant to determining which items should be excluded from the tax base.

Other deviations are rightly considered tax expenditures, meaning they are simply policy choices made by Congress to give preferential treatment in certain circumstances. In those cases, the payer is sometimes relevant. For example, fringe benefits are excluded when paid by an employer, but similar payments made outside of the employment scenario may not be exempt. Similarly, interest on bonds paid by private issuers is taxable, whereas interest on bonds paid by state and local governments is exempted by Code section 103. However, most tax expenditures are accompanied by some identifiable policy justification for the special treatment.[232] For example, the exclusion of interest on state and local bonds acts as a subsidy to state and local government programs that are funded by such bonds.[233]

In the case of taxable nudges and BBS, the payer is the single most important factor in determining taxability. However, the policy reason for this is not always clear. Whereas specific tax expenditures may exempt

[231] For example, if a taxpayer owns an asset that appreciates in value (e.g., a stock or a house), she has a positive change in net wealth. However, the Code will not tax her until she "realize[s]" a gain, such as by making a sale. See I.R.C. § 1001.

[232] For a discussion of the legislative history behind the section 132 fringe benefit rules, see infra notes 261–67 and accompanying text.

[233] See Scott Greenberg, Reexamining the Tax Exemption of Municipal Bond Interest, Tax Found. Fiscal Fact No. 520 (July 2016), https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF520.pdf [https://perma.cc/ZY7A-QS3M]. (observing that state and local bonds are justified as a basis for incentivizing investments in projects that benefit nonresidents, but concluding that "[a] tax exclusion is an unideal policy design for subsidizing state and local debt").

income in order to achieve policy goals set by Congress, the rules governing taxability of nudges and BBS are an ad hoc assortment that has evolved over time. In some cases, there is no obvious policy reason for varying the treatment based on the payer when two payments might have an identical policy goal. A payment to mitigate the harm of drug addiction from the government might be taxable, whereas an economically identical payment from a nonprofit might be tax-free. A payment to mitigate earthquake damage made by an insurance company is likely an excludable purchase price adjustment, but an identical government payment is taxable.

As discussed further below, there is no good justification for taxing government nudges when similar payments from private parties are tax-exempt. Accordingly, Section III.C proposes reforms that would exclude many such government nudges from income.

Other than government payments, the other taxable category of nudges is payments from employers that do not otherwise qualify as fringe benefits, or for another exclusion. In this case, taxability makes sense and major reform is not necessary. Congress has legislated broad exclusions in the area of employment that cover many types of payments, particularly if they relate to business, health insurance, or medical care. These exclusions cover most of the nudges discussed here. Payments that occur outside of those settings are presumptively compensation, which is a fair assumption. Employers generally do not make payments out of generosity or even moral duty; rather, they make payments to employees for business reasons. If a particular nudge from an employer were not excluded and Congress desired otherwise, it would make more sense to legislate an incremental reform to a statute like section 132, as opposed to enacting a statute aimed at nudges. For example, if Congress deemed a particular wellness plan benefit to be good policy, and wanted to exclude it from income, lawmakers might add the benefit to the list of excluded fringes under section 132.

To summarize the current state of the tax law, it is useful to separate nudges (and BBS) into categories based on the payer. Incentives provided by employers are generally tax-exempt as long as they qualify as a fringe benefit or medical expense. Incentives provided by private third parties like insurance or utility companies are generally excluded under the purchase price doctrine. Incentives provided by charitable nonprofits are generally excluded as gifts. The outlier is incentives provided by the government. While payments based on economic need or to disaster victims are exempt under the general welfare doctrine, most other government incentive payments are taxable. As will be discussed further below, the policy justification for these differing treatments is unclear.

The tax treatment of the various types of nudges is summarized in the table below.

Table 1: Tax Nudges Provided by Various Actors

Payer	Tax Treatment	Examples
Employer	Tax-free if medical care, health insurance, or a defined fringe benefit Taxable Compensation	Wellness program benefits like health screenings, token gifts Any cash prize
Utility Company	Tax-free purchase price adjustment	Free lightbulbs, rebates for home improvements
Insurance Company	Tax-free purchase price adjustment	Rebates or discounts for achieving health goals
Nonprofit/Charity	Tax-free gift	Red Cross disaster aid
Government	Tax-free if need-based Taxable if not need-based	Disaster relief grant Disaster mitigation grant

B. What's Wrong with Taxing Nudges?

Before turning to the policy implications of the above-described tax regime, it is useful to consider the consequences. Does it matter if we tax nudges? Imposing income tax on an incentive lessens its value, but one response would be to gross-up the amount of the incentive. For example, if a government wanted to offer a $1,000 subsidy but a tax of 20% (or $200) would be owed, the government could instead make the subsidy $1,250.[234] Although this results in a circular flow of funds in the case of

[234] In that case, 20% or $250 would be tax, and $1,000 would remain.

a federal subsidy,[235] it is not necessarily so in the case of federal tax on a state or local incentive. Regardless, from a purely economic perspective, the cost of taxing nudges can be accounted for by increasing the incentive.

This Article, however, is concerned with the noneconomic cost of taxing nudges and BBS. The very premise of these payments is that sometimes noneconomic incentives can encourage desired behavior. It is a logical corollary that noneconomic costs may similarly deter desired behavior. If taxing incentive-based nudges imposes a friction that deters people from wanting to accept those incentives, then taxing nudges will be counterproductive. In other words, the cost of taxing nudges may be more than the economic cost of the tax itself.

1. Tax as a Friction to Nudges

To date, no studies have specifically examined the cost of imposing tax on nudges or BBS. However, some inferences can be drawn from related studies. Accordingly, this Subsection examines attitudes towards taxes and how various "frictions" other than tax influence peoples' take up of benefits. The key inference from this literature is that taxes may discourage people from wanting to accept incentive-based nudges and BBS. If they avoid the nudge to avoid the tax, then policymakers' goals in implementing the nudge will be thwarted.

a. Tax Aversion

Many people strongly dislike taxes. The phenomenon is often described as "tax aversion," which can be thought of as the psychological cost imposed by taxes beyond their financial cost.[236] Researchers have observed tax aversion in studies showing that people overweight the cost of a tax when making financial decisions, treat tax costs differently than

[235] If the federal government increases a federal subsidy from $1,000 to $1,250 to account for federal income tax, it will pay $250 more for the subsidy and collect $250 in tax.

[236] See, e.g., Christopher C. Fennell & Lee Ann Fennell, Fear and Greed in Tax Policy: A Qualitative Research Agenda, 13 Wash. U. J.L. & Pol'y 75, 79 (2003) ("A functional definition of . . . tax aversion . . . is the amount by which one's aversion to a tax exceeds the economic cost of the tax."); Edward J. McCaffery & Jonathan Baron, Thinking About Tax, 12 Psych., Pub. Pol'y & Law 106, 117 (2006); Abigail B. Sussman & Christopher Y. Olivola, Axe the Tax: Taxes Are Disliked More than Equivalent Costs, 68 J. Mktg. Rsch. S91, S91 (2011).

other costs,[237] and behave differently depending on whether a fee is labeled as a "tax" or not.[238] Tax aversion may explain real world scenarios like the enormous popularity of sales tax holidays at retail establishments or the overinvestment in tax-exempt bonds by individuals for whom the economic return is unfavorable.[239]

For example, in one experiment, participants were presented with the hypothetical option of investing money in either a riskless savings account that earned $75 per year, or a risky bond that earned $120 per year.[240] Some participants were told the bond was tax-exempt and yielded $120 of interest.[241] Others were told the bond was taxable, yielded $160 of interest, but would yield an after-tax return of $120.[242] In other words, the economics of the tax-exempt bond and the taxable bond were identical.

Although the financial return on the two bonds was the same, people were far more likely to choose the bond over the savings account in the tax-exempt scenario (88%) compared to the taxable scenario (18%).[243] Similarly, another experiment compared a simple investment choice between a taxable bond with a $300 after-tax yield to a tax-exempt bond with a $300 yield, and the majority of subjects (77%) favored the tax-exempt bond.[244]

In yet another experiment, subjects were asked how much of a discount they would require to wait in line at a store for 15 minutes to purchase a jacket.[245] When the discount was framed as a "customer rewards" sale, participants demanded a higher percentage discount. But they were willing to accept a lower percentage discount to wait in line when that

[237] See, e.g., Sussman & Olivola, supra note 236, at S93 (describing experiments that found people change their behavior to avoid taxes, but not reacting in a similar manner to comparable non-tax costs).

[238] McCaffery & Baron, supra note 236, at 117–18 (recounting an experiment the authors conducted where individuals were confronted with a policy labeled as a tax or comparable economic policy not labeled as a tax, which "found that labels mattered"); David J. Hardisty, Eric J. Johnson & Elke U. Weber, A Dirty Word or a Dirty World? Attribute Framing, Political Affiliation, and Query Theory, 21 Psych. Sci. 86, 91 (2010) (finding in an experiment that "framing the cost increase as a tax differentially affected the structure and content of thoughts generated by Democrats and Republicans, leading to different preferences").

[239] Sussman & Oliviola, supra note 236, at S94–96, S100.

[240] Id. at S95.

[241] Id.

[242] Id.

[243] Id.

[244] Id. at S95–96.

[245] Id. at S94.

discount was described as an "axe-the-tax" sale that would allow for a tax-free purchase.

These and other studies indicate that, for many people,[246] the presence of a tax distorts rational cost-benefit analysis. This has important implications for financial incentives designed to encourage certain behaviors. Although they may be constrained by budgets, policymakers or researchers may set incentive amounts based on what they determine is an optimal amount. For example, a local government may decide $500 is too small of a grant to encourage people to retrofit their homes to protect against earthquakes, but that $1,000 is the "right" amount.

If the grant were subject to tax at a rate of 20%, policymakers might raise the amount (i.e., gross up) to $1,250 so that the after-tax grant is still $1,000. However, as in the above-described experiments, tax aversion may lead people to value a taxable grant at something less than the after-tax amount. For example, an individual might view a taxable grant that is worth $1,000 after-tax to be equivalent to only an $800 payment in their mind. In that case, they may choose not to accept the grant and make the desired improvements.

Put more simply, tax aversion may reduce the effectiveness of financial incentives because people do not like to pay tax. Individuals may be willing to forego incentives that are in their economic interest out of a desire to avoid the tax.[247] And although some studies indicate that tax-aversion bias may wear off over time with experience, nudges and BBS are more likely to be one time or infrequent incentives, which are much more susceptible to tax aversion.[248]

[246] One source of variation appears to be political affiliation. Studies show that Republicans and Independents are sensitive to "tax" labels in decision making, but Democrats generally are not. See id. at S96–97; Hardisty et al., supra note 238, at 91 (finding "that the power of a framing manipulation can depend on participants' preexisting individual differences").

[247] Of course, tax aversion will not deter participants who are unaware of the tax, which may be the case when there is no information reporting required. For incentives subject to information reporting (discussed more below), participants will likely have to provide tax information at the outset (e.g., a Form W-9), and are more likely to be aware of tax consequences. Other programs may disclose tax consequences on their website or in related materials, as is the case with California's Earthquake Mitigation program. See infra note 272.

[248] See generally Kay Blaufus & Axel Möhlmann, Security Returns and Tax Aversion Bias: Behavioral Responses to Tax Labels, 15 J. Behav. Fin. 56, 63–65 (2014) (finding that people have tax aversion bias toward infrequent, unfamiliar financial decisions).

b. Tax Avoidance

Another reason people might be less inclined to respond to taxable financial incentives is because they do not want to have any income reported to the IRS. These concerns are not unfounded, since many nudges and BBS will be reported to the government by the payer. Generally, miscellaneous payments to non-employees of $600 or more must be reported on a Form 1099-MISC, which gets sent to both the taxpayer and the IRS.[249] For example, the IRS has ruled that earthquake retrofit grants are subject to this information reporting.[250]

This information reporting on its own, independent of tax aversion, may deter some people from accepting such grants. For people who currently do not file tax returns, work in cash-businesses, underreport their income, or otherwise take part in the underground economy, they may view the receipt of a 1099 as a red flag for the government that they would like to avoid.

c. Complexity and Benefits Take Up

Another reason that taxing financial incentives may deter taxpayers is complexity and the hassle of dealing with the tax obligation. This is separate from disdain for paying taxes in general and from the desire to avoid tax information reporting. Some people may be willing to report and pay the tax in theory, but simply not want to have to deal with the trouble of doing so. If the perceived hassle cost is high enough, people may turn down taxable incentives even when those incentives are economically attractive.

What researchers call "hassle factors" have been shown to inhibit desirable behavior such as undergoing medical screenings or applying for food stamps.[251] As commentators have described, "[w]hereas hassle costs may appear to a classical economist as too minor to be taken seriously, such hassles are likely to be especially detrimental in the context of program take-up."[252]

---

[249] See I.R.C. § 6041(a).

[250] I.R.S. Priv. Ltr. Rul. 201816004 (Apr. 20, 2018); I.R.S. Priv. Ltr. Rul. 201815005 (Apr. 13, 2018).

[251] Marianne Bertrand, Sendhil Mullainathan, & Eldar Shafir, Behavioral Economics and Marketing in Aid of Decision Making Among the Poor, 25 J. Pub. Pol'y & Mktg. 8, 16 (2006).

[252] Id.

For example, one study examined the role of "psychological frictions" in the failure of eligible recipients to claim the Earned Income Tax Credit.[253] Researchers found that providing eligible claimants with simplified information and forms in a second reminder notice increased take-up.[254] This led them to conclude that "confusion, program complexity, and lack of program awareness play a significant role in the failure to take-up, while stigma, and high perceived economic costs of claiming, do not."[255]

Taxing nudges may present an analogous impediment to their efficacy. Many individuals find the tax system daunting and confusing,[256] and concerns over how to report taxable payments, or having to come up with liquid funds to pay the tax on reported payments, may discourage take-up. This is further exacerbated by the fact that taxable nudges and BBS are subject to information reporting but *not* to withholding (other than incentives paid by employers).[257] In the absence of withholding, taxpayers will have to budget for the taxes owed and potentially make a payment with their return, an unappealing prospect for many people.[258]

d. Payer Reporting Obligations

Another downside of taxing nudges is that the payer, i.e., the entity offering the incentive, may be deterred from offering the incentive if it comes with tax reporting obligations. As discussed above, payers generally have an obligation to issue a 1099 for payments of $600 or more.[259] Failure to do so may result in penalties.[260] For the same reasons

[253] Saurabh Bhargava & Dayanand Manoli, Psychological Frictions and the Incomplete Take-Up of Social Benefits: Evidence from an IRS Field Experiment, 105 Am. Econ. Rev. 3489, 3490 (2015).

[254] Id. at 3524.

[255] Id. at 3492.

[256] See Kathleen DeLaney Thomas, User-Friendly Taxpaying, 92 Ind. L.J. 1509, 1512 (2017).

[257] Tax withholding is required on payments of employee compensation, but not for other payments. See I.R.C. § 3402(a).

[258] See, e.g., Thomas, supra note 94, at 84.

[259] See supra note 249 and accompanying text.

[260] Penalties are up to $270 per information return (up to $550 in the case of intentional disregard) and may be assessed separately for both failure to issue to the payee and failure to file with the IRS. For a summary of these penalties, see Increase in Information Return Penalties, IRS, https://www.irs.gov/government-entities/federal-state-local-governments/increase-in-information-return-penalties [https://perma.cc/F2NZ-K4CL] (last visited July 17, 2019).

that recipients might be deterred by taxes on incentives, payers may also be deterred. For example, they may be reluctant to attract IRS scrutiny, fear penalties if they misunderstand reporting requirements, or want to avoid the hassle or additional economic cost of having to undertake information reporting.

2. Uncertainty

As discussed in the preceding section, taxing nudges may counteract the effectiveness of the nudge for a number of reasons, including deterring both the intended recipient and the payer. Even putting aside those serious concerns, taxing nudges creates problematic uncertainty in the tax law.

There are several reasons why taxing nudges creates uncertainty. It is likely surprising and counterintuitive to many people that government grants would be taxed. Having a surprise tax obligation, in turn, may encourage negative views about the tax system, and may also lead to unintentional noncompliance. For example, a person may get a 1099 at the end of the year showing taxable income and be unable to afford the tax because they did not budget properly in advance.

Furthermore, varying the tax treatment of incentives based on the payer is likely confusing, and makes the law harder to predict and understand. As discussed above, a grant from a charity may be a tax-free gift while an economically identical grant from a city may be taxable.

One response to this uncertainty is as follows: Taxable nudges often go unreported, and the IRS is unlikely to find out or enforce penalties in this area. So, one might ask, what is the harm? But even if parties are keeping nudges off the IRS's radar, or if a resource-constrained IRS simply looks the other way, widespread non-reporting is harmful to the tax system as a whole. This is true notwithstanding that relatively low amounts of revenue may be at stake. Congress recognized this potential harm decades ago in the somewhat analogous context of employer fringe benefits.

Before code section 132 was enacted in 1984,[261] there was widespread noncompliance when it came to noncash compensation from employers. Many employers provided such benefits and did not report them, and the IRS had informally blessed these arrangements through a combination of

[261] Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 499 (codified as amended in scattered sections of 26 U.S.C.).

non-enforcement and private rulings.[262] Yet notwithstanding the IRS's complacence, Congress decided to take action. In creating a specific statutory exclusion for certain fringe benefits, the legislative history to section 132 cites several justifications.

First, Congress recognized that employers often have a genuine business purpose, apart from compensation, to offer fringe benefits, which justifies exclusion even though the employee receives an economic benefit.[263] Second, Congress recognized that the lack of clarity and selective enforcement around fringe benefits resulted in "inequities, confusion, and administrative difficulties" for both taxpayers and the IRS, which Congress deemed "unacceptable."[264] Third, Congress recognized that failing to set well-defined limits would result in too many untaxed fringe benefits and erode the tax base.[265] Finally, Congress noted that "unrestrained expansion of noncash compensation" would result in inequities, because employees in certain lines of business would have access to untaxed compensation and others would not.[266] In sum, Congress decided that codifying what was already a widespread practice of non-reporting fringe benefits "substantially improves the equity and administration of the tax system."[267]

Much of the logic behind the enactment of section 132 applies in the case of nudges, as well. Like fringe benefits, nudges are often offered for a non-compensatory purpose, making them distinguishable from traditional, taxable forms of payment. Further, non-reporting of nudges by some is bound to result in inequity and confusion. Even if many taxpayers are not reporting nudges in practice, a clearly defined system of exclusions would result in a more equitable and administrable tax system.

3. Implications for the Efficacy of Nudges and BBS

Many taxpayers are likely unaware that incentive-based nudges are taxable. If taxing nudges does not line up with peoples' intuitions about what kind of income is taxable, there is more likely to be resentment and other negative responses to such taxes, as well as potential

[262] See Staff of J. Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 840 (Comm. Print 1984).
[263] Id.
[264] Id. at 841.
[265] Id.
[266] Id.
[267] Id. at 843.

noncompliance. Furthermore, as discussed above, even setting aside taxpayer confusion and noncompliance, a tax obligation might deter taxpayers from taking up incentives altogether. Whereas a nudge is meant to reduce psychological frictions that prevent people from making desirable choices, taxing nudges may simply introduce a new friction.

Several implications flow from these observations. First, further study is needed regarding how taxing nudges may influence behavior, particularly the take up of incentive-based nudges and BBS. While researchers have specifically examined other psychological frictions to benefit take up, to date, tax itself has not been studied as a source of friction. For example, if participants in a study are willing to quit smoking in exchange for cash payments, what would be the impact of also telling those participants the payments will be taxed? Would participants demand a higher incentive or, instead, no longer want to participate? Researchers have largely overlooked this potential friction. And while tax aversion is a well-documented phenomenon, it would be useful to study whether people are more or less susceptible to it in the context of nudges.

Further, policymakers may want to consider tax consequences in their design of nudges or BBS. If an incentive is taxable and another alternative is not, the non-taxable nudge may be a better choice for influencing behavior. On the other hand, to the extent a certain incentive is not taxable (for example, because it is excluded under a specific Code provision), promoting it as "tax free" may make it more attractive given what we know about tax aversion. Finally, policymakers might consider taxation in deciding whether to choose a "nudge" at all as opposed to a traditional incentive. It may turn out, for example, that a penalty on undesirable behavior may be more effective than an incentive that will be taxed.

C. Potential Reforms

Given that the current tax regime for nudges is confusing and somewhat arbitrary, and given that taxing nudges may counteract their effectiveness,[268] reforms may be in order. This section discusses potential options for reform that range from modest proposals to more fundamental changes to the Tax Code.

[268] Equally important, but beyond this Article's scope, are potential federalism and comity concerns that may arise when the federal government seeks to tax state programs, to the extent the tax hinders the state's ability to implement the program.

One reform has already been proposed, although its scope is narrow. In the case of earthquake mitigation payments, which the IRS has ruled are taxable, members of Congress from California have proposed federal legislation that would exempt such payments from tax.[269] Specifically, the bill proposes amending Code section 139 to add a paragraph that would exclude "qualified earthquake mitigation payment[s]," which include grants, credits, or loans paid pursuant to an earthquake loss mitigation program established by a state.[270] In promoting the bill, Senator Dianne Feinstein stated: "Our bill makes sure Californians aren't taxed for participating in lifesaving earthquake preparation programs, like the Earthquake Brace + Bolt program . . . . We must do all we can to encourage earthquake-readiness and this bill will make it easier for Californians to take the necessary steps to protect their families."[271] The proposed exclusion is sensible. Not taxing the mitigation grants will make the grants more attractive, which in turn may make Californians more likely to undertake measures to improve their homes.[272]

However, the California lawmakers' proposal covers only one narrow incentive—earthquake mitigation grants—and leaves untouched the tax treatment of other programs that may have a similar focus and face the same tax treatment. While the intent behind the proposal is laudable, a broader approach would be better than a piecemeal approach. Broader reforms would impact more taxpayers and, ideally, be able to address future incentive-based programs as they arise.

1. Taxing Government Grants: Change the Default

As discussed above, many nudges and BBS are excluded from income under the Code as long as the payer is someone other than the

[269] See Earthquake Mitigation Incentive and Tax Parity Act of 2017, H.R. 1691, 115th Cong. (2017); Earthquake Mitigation Incentive and Tax Parity Act of 2017, S. 2104, 115th Cong. (2017).

[270] Id.

[271] Press Release, Senator Dianne Feinstein, Feinstein and Harris Introduce Legislation to Protect Earthquake Loss Mitigation Incentive Ahead of Senate GOP Tax Bill Release (Nov. 9, 2017), https://www.feinstein.senate.gov/public/index.cfm/press-releases?ContentRecord_id=78BD9E69-4090-4E62-AE1A-08A01870F3AB [https://perma.cc/L7UZ-BY8G].

[272] The Brace + Bolt program mentions potential consequences in an FAQ on its website, stating, "The homeowner of a retrofit House under the Program will receive an IRS Form 1099, if applicable, reporting the amount of incentive payments as taxable income to the homeowner for federal income tax purposes." See Earthquake Brace+Bolt FAQs, https://www.earthquakebracebolt.com/FAQ [https://perma.cc/GXF5-HMEU] (last visited July 24, 2019).

government. Employer benefits are often excluded as fringe benefits under section 132, payments from nonprofits will often be treated as gifts, and payments in the commercial context will generally be treated as purchase price adjustments. The biggest shortcoming of the current tax regime for nudges and BBS is that payments from a government are taxable under the Code, even when they may be economically indistinguishable from similar payments from a private party. Furthermore, government grants are often taxable, while an economically identical tax credit may not be.[273] In many cases, this result is nonsensical and, as discussed above, the tax on a grant may counteract its effectiveness. In some cases, the very reason for offering a grant versus a tax credit may be that the grant appeals to peoples' behavioral preferences.

Under current law, government transfers are taxable as a default matter (like any other income),[274] yet the Code and IRS administrative rulings are full of exceptions. In fact, exceptions to the default taxability of government transfers are so widespread that they nearly swallow the rule. This prevalence likely contributes to confusion and widely held beliefs that government payments are not taxable.

A wholesale move to exclude all government transfers from income is not viable, nor is it sensible. Some government transfers are rightly treated as income. For example, unemployment insurance payments are taxed as income,[275] which is the right result, because they are a substitute for wages one would earn from working.[276] Similarly, salary paid to government employees should clearly be taxable compensation, just as wages from a third party would be. Further, while Social Security retirement benefits are excluded from income for many taxpayers, requiring income exclusion for taxpayers over a certain income threshold has the effect of imposing higher marginal tax rates on those earners.[277] Commentators

---

[273] Although state tax credits are generally not taxable, to the extent they reduce a taxpayer's state tax liability, the refundable portion (if any) of a state tax credit is taxable. See, e.g., Ginsburg v. United States, 922 F.3d 1320, 1322 (Fed. Cir. 2019) (holding that the refundable portion of a New York State tax credit was includible in income for federal income tax purposes).

[274] See supra notes 134–35 and accompanying text.

[275] I.R.C. § 85. However, prior to the enactment of section 85, the IRS treated unemployment payments as excludable. See Rev. Rul. 70-280, 1970-1 C.B. 13.

[276] Failing to tax unemployment compensation also favors such compensation over wages, which may distort decisions to work.

[277] See I.R.C. § 86. Previously, the IRS treated all Social Security benefits as exempt from tax. See Rev. Rul. 70-217, 1970-1 C.B. 13.

have also noted that retirement benefits should be taxed because, like unemployment payments, they are substitutes for wages.[278]

So how could policymakers create a broad, generalized rule that would exclude nudges and BBS while continuing to tax government transfers that should be taxable? The more traditional approach would be to carve out the desired payments and pass legislation excluding them from income. However, a significant drawback to this approach is that it requires either a narrow scope (as in the case of the earthquake mitigation payment proposal) or requires creating a broad definition of excludable nudges. The latter approach, discussed further below, has its own challenges. How would one define "nudge," and decide which should be taxable and which should be excluded? How would one write a statute that would adequately capture future behavioral interventions that do not yet exist but would warrant exclusion from the tax base?

But there is another approach to reform that avoids these obstacles. Policymakers could simply shift the default approach to taxing government transfers—from taxable to not taxable. In other words, government transfers would be excluded from income for federal income tax purposes *unless* specifically included by the Code.[279]

For nudges and BBS paid by governments, this creates an ideal rule, which is a default of non-taxability. If policymakers determine that a specific behavioral intervention should have tax consequences, they could legislate an inclusion rule. But in the absence of a reason to tax nudges, they would remain tax-free. The approach itself acts as a nudge for lawmakers, requiring active departure from a desired default.

A default exclusion rule for government transfers would require only minor adjustments to the Tax Code because the taxability of many government transfers is already codified notwithstanding the default inclusion rule of section 61. For example, unemployment compensation would continue to be taxable per Code section 85, as would certain Social Security retirement benefits per section 86. In those cases, no amendments to the Code would be needed. Nor would Congress have to repeal Code sections that exclude certain government transfers from income, though it would be logical to do so. While such exclusions would

[278] See, e.g., Forman, supra note 204, at 795. But see Brian Galle, How to Save Unemployment Insurance, 50 Ariz. St. L.J. 1009, 1062–64 (2018) (arguing for repeal of taxes on unemployment benefits).

[279] Professor Charlotte Crane has observed that this appears to have been the IRS's historical approach prior to the evolution of the general welfare doctrine. Crane, supra note 217, at 594.

be redundant under a broad change in the default rule, the tax treatment of those exclusions would remain the same.[280]

For other taxable government transfers that are not specifically included in income via statute, a relatively simple statute could include them. For example, Congress might enact legislation providing first in paragraph (a) that all transfers from a government entity are excluded from taxation unless otherwise provided in the Code. The legislation could then have a second paragraph, (b), providing that paragraph (a) does not apply to the following payments, with a list of exceptions.

For example, any payment that is compensation for services should be on the list of exceptions in the statute (i.e., treated as income). Although providing a list of exceptions to the default rule may, at first, appear to undercut the simplicity of this approach, the list of exceptions is likely shorter and simpler than the reverse approach. In other words, so many government transfers are *excluded* from income already that it is easier to make exclusion the default and list the inclusions.

Shifting the default for government transfers will not change the current treatment of most transfers. Social welfare benefits like TANF will continue to be excluded, as will many Social Security benefits. The new rule would, however, obviate the general welfare doctrine. Recall that the administratively created rule required a showing of "need" to treat a government transfer as exempt.

With a default exclusion rule, there would no longer need to be a demonstration of economic need or hardship from disaster. This is a preferable approach. Compensating victims of disaster and providing benefits to needy individuals is an appropriate government policy. But providing incentives that help *prevent* these scenarios—for example by keeping people healthy and free of medical expenses or by making peoples' homes safe—is an equally worthy goal. What's more, the latter approach is often more cost effective and may prevent future loss. There is no justifiable reason to exempt payments, from tax, that clean up a mess and not exempt payments designed to prevent a mess from happening in the first place. Accordingly, the effective replacement of the general welfare doctrine with a broader exclusion would improve the tax system.

[280] Examples include current exclusions for educational grants, veterans' benefits, and worker's compensation payments. See, e.g., I.R.C. § 104(a)(1) (worker's comp), I.R.C. § 117 (scholarships), 38 U.S.C. § 5301 (veterans' benefits). Similarly, Medicare benefits, which are not specifically excluded by statute but are treated as such by the IRS, would continue to be excluded. See Rev. Rul. 70-341, 1970-2 C.B. 31–32.

Perhaps the biggest upside of this approach is it accounts for future interventions that have yet to be implemented. As discussed in Part I, the use of nudges and BBS by governments has grown considerably in the last decade. Further, policy priorities inevitably shift over time. Investment in energy efficient appliances and other technologies is a focus in 2020 but was not fifty years ago. As policymakers find new ways to incentivize behavior that is productive to health, the environment, or other contexts, a default exclusion statute ensures that tax will not create an impediment. And if, after careful deliberation, Congress determines that taxing a particular government program is appropriate, they will be able to do so.

2. Targeted Legislation

Creating a broad, default exclusion for government transfers would effectively repeal a long-standing IRS rule (i.e., the general welfare doctrine) that requires a showing of need to exempt government transfers. Furthermore, if the exceptions in the statute were drafted too narrowly, government transfers that *should* be taxable may inadvertently end up being exempt by default, and Congress may act slowly to resolve the problem. If enacting a broad default statute were deemed to be undesirable for these reasons, a narrower approach would be to instead enact a statute that specifically excludes certain nudges and BBS from income. The goal would be to write a statute that only touches upon nudges and BBS that are rightly excluded from income, but yet is written as broadly as possible.

Most of the incentive-based nudges and BBS discussed in Part I can be grouped broadly into the categories of health and the environment. Here, "environment" encompasses both prevention of natural disasters like earthquakes and a focus on green initiatives that encourage reliance on cleaner and more efficient energy sources. With this in mind, lawmakers could draft a statute that broadly excludes nudges and BBS in these two areas.

For example, a new statute might provide that "Gross income does include any 'qualified public policy subsidy.'" "Qualified public policy subsidy" could then be defined by the statute as: "any payment or other incentive provided pursuant to a federal, state, or local government program to promote health or to protect the environment." The statute could further define the concepts of "health" and "environment." However, the statute should be drafted broadly with authority granted to

Treasury to draft regulations regarding specific programs or fact situations. This would allow for the most flexibility and ability to update the rules.

For example, the statute might specify that qualified public policy subsidies include grants paid to mitigate or prevent damage to homes from natural disasters, as well as subsidies paid to purchase energy efficient products for the home. But Treasury regulations might specify which natural disasters (e.g., floods, earthquakes) are contemplated by the statute, as well as which types of energy efficient products are covered. The same goes for health. The statute might cross-reference the Code's definition of "medical care"[281] to define health, but regulations might clarify that, for example, cash payments made as part of drug addiction programs are exempt.

A "nudge tax" statute may be more politically palatable than a general default statute for government transfers due to its narrower scope. It is also less likely to have unintended consequences, such as inadvertently excluding transfers from income that should clearly be taxable. But the nudge statute comes with a significant drawback in that it may be under-inclusive. Further, attempts to adequately define subsidies that relate to health and the environment may lead to a complex and hard-to-read statute.

What's more, enacting a nudge tax statute makes it hard to account for potential new categories of nudges and BBS. It is perfectly feasible that, in ten years, an entirely new category of incentives wholly outside the context of health and environment will emerge with strong justifications for tax exemption. Yet, if not covered by the current Code, government transfers will continue to be taxable as a default matter.

An analogous situation has occurred with section 132's exclusion for fringe benefits. Recall that, in enacting section 132 in the 1980s, Congress attempted to carve out a list of fringes that should be excluded from taxation, based on common practices at the time.[282] Since its original enactment, Congress has made few updates to section 132, yet fringe benefits have evolved well beyond what its drafters could have possibly contemplated over 30 years ago. For example, Silicon Valley companies now frequently offer onsite lifestyle benefits like free meals, laundry, and fitness classes that were unheard of in decades past.[283] Work-provided

[281] See supra note 167.
[282] See supra notes 261–67 and accompanying text.
[283] See supra note 172.

cellphones, a staple in the 21st century at many jobs, did not exist at the time of the original statute.[284] As a result, the tax treatment of these newer benefits is uncertain, recreating the scenario that section 132 was designed to avoid: the inequitable provision of tax-free benefits, sporadic informal guidance, and confusion.[285]

One way to avoid this fate would be to delegate much of a nudge statute's scope to regulations, which is generally not the approach taken by section 132.[286] Regardless, there is a real risk that a nudge statute will look outdated from a policy perspective several decades into the future.

One remaining issue regarding the scope of a nudge statute is whether it should apply to government transfers only, or instead apply more broadly. The statute could be drafted such that qualified public policy subsidies were defined with respect to the nature of the program (health or environmental) but without reference to the payer being a government. The upside of this approach is that it would unify and simplify the tax treatment of incentive-based nudges. Rather than a collection of various statutes and doctrines applying—the purchase price adjustment doctrine in some scenarios, the gift exclusion in others, or section 132's exclusion for fringe benefits—all transfers of a similar nature would be treated the same, regardless of the payer.[287]

However, in some cases, there may be good reason to treat payments differently based on the payer. Consider a program designed to provide cash awards to help people adopt healthy lifestyles (e.g., exercise or smoking cessation). When coming from a government, such an award looks like a true nudge or BBS. But when coming from an employer, the treatment is less certain. Employers may hope that such awards will help them attract and retain talented employees, suggesting a compensatory nature. One could argue that the statutory framework provided by sections 105, 106, and 132 already governs when employer benefits should be excluded, and accordingly, a nudge statute should not cover employer incentives.

[284] See Soled & Thomas, supra note 120, at 763–64, 776.

[285] Id. at 814–15.

[286] While section 132 contains a list of specific exclusions in the statute, section 132(o) does delegate authority to Treasury to implement the statute and numerous regulations exist, such as those clarifying what types of benefits qualify as de minimis fringes. See Treas. Reg. § 1.132-6 (as amended in 1992).

[287] Cf. Crane, supra note 217, at 612–13 (discussing the exclusion of transfer payments that do not create new value, regardless of source).

A reasonable compromise approach that responds to this argument would be to extend the nudge statute beyond government transfers, but specifically exclude transfers from employers. Since transfers from charitable organizations are almost always excludable as gifts in this context, and transfers from private parties (like utility companies or health insurers) will generally be excluded under the purchase price doctrine, a unified approach makes sense for these payers. Accordingly nudge tax statute might exclude all health and environment related public policy subsidies from income, while carving out only employer payments.

3. Require Withholding on Taxable Incentives

If neither a general default exclusion statute nor a nudge tax statute were enacted, there are a few remaining possible scenarios. First, Congress might do nothing, which will leave many government nudges and BBS taxable. Second, Congress may enact a small number of piecemeal reforms, like the proposed Earthquake Mitigation Incentive and Tax Parity Act, which will have limited impact. There is one more modest reform that lawmakers could enact, however, that would help mitigate the problems created by taxing nudges and BBS. Specifically, Congress could require tax withholding on these payments, so that recipients do not have to make tax payments when they receive the incentive.[288]

Because the current withholding rules only apply to payments from employers, many nudges and BBS will not be subject to tax withholding. This means the recipients may have surprising tax bills, which may create negative perceptions about the relevant programs. For participants who know they will owe taxes, concerns about budgeting for the tax or having to deal with the payment may deter them from claiming the incentive. Withholding tax from nudges and BBS could go a long way towards overcoming some of the psychological frictions described in Section III.B. Ample research suggests that withholding makes paying taxes less painful for people, and if people receive only after-tax funds, they may not view the tax payment as a loss at all.[289] As I have advocated in earlier work, policymakers could expand withholding rules to cover many types

[288] Withholding could be set at a default rate (e.g., 5%), or taxpayers could fill out a form that would determine their withholding rate. These possibilities are discussed in Thomas, supra note 94, at 131–34.

[289] See id. at 111.

of payments outside of the employment context, including nudges and BBS.[290]

CONCLUSION

Nudges present governments with a cost-effective way to promote welfare in areas like health, environmental protection, and education. Sometimes even a modest incentive can help people overcome present bias or other irrational tendencies, and make better choices. But when those incentives are taxable, they are inherently less attractive.

The current tax rules were simply not designed with nudges in mind. As a result, government transfers that promote good policies, like mitigating natural disaster harms, are subject to taxation. Confusingly, similar transfers from private parties are not. Other examples will continue to arise as governments expand their use of nudges and behaviorally based subsidies.

Rather than trying to play catch-up with each new nudge, Congress could enact a relatively simple and permanent fix: exempt government transfers as a default matter and tax only specifically legislated inclusions. Such a change would modernize the Tax Code to account for a new source of income not contemplated by the original drafters. The rule would also allow governments to innovate without the threat of taxation counteracting new policies.

[290] Id. at 128.