

The General Welfare Exception To Gross Income

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For decades, tax practitioners have done more than pay lip service to the all-inclusive properties of section 61. Courts have told us over and over that gross income is, after all, income from whatever source derived, be that wages, gains, prizes, or treasure trove.¹ Indeed, \$1 million found inside a piano is clearly includable in income to the lucky finder.² So is that \$20 you found on the street; never mind that the person who lost the money probably can't claim a deduction. Who said tax is fair?

Recently, we celebrated a milestone birthday for *Glenshaw Glass*,³ a case underscoring the nearly limitless reach of the gross income concept. Who can forget its cogent holding? Income exists whenever there is an accession to wealth, clearly realized, and over which taxpayers have complete dominion and control. Although it might appear that *Glenshaw Glass* is graying a bit around the edges as it turns 50 this year, that pillar of tax law jurisprudence is stronger than ever. Thirty-four cases and 13 law review articles have cited it just since 2004. Historically, the case commands over 1,000 case citations, including 15 from the Supreme Court, and 320 separate law review articles.

Even though most practitioners may find it difficult to remember the facts of the case,⁴ there is a persistent symbiosis between *Glenshaw Glass* and the accession to wealth doctrine. Nearly every tax textbook includes a chapter revolving around it, so tax lawyers start their careers with the case. *Glenshaw Glass* is a staple of tax doctrine.

Because of *Glenshaw Glass*, everyone knows that virtually everything constitutes income for tax purposes. In fact, it seems the breadth of the gross income concept is nearly limitless. Nevertheless, a little-known administrative exception exists that circumvents the case law and its income inclusion mandate. It is called the general welfare exception (GWE).

Under the GWE, some government payments do not constitute gross income to the recipients. While the IRS has applied the GWE doctrine to a handful of disparate government payments, historically, the classic example of the GWE's application is a government payment made to victims of a natural disaster. For example, although the IRS has not ruled on this particular issue, payments made by the Federal Emergency Management Agency to hurricane victims are of the type of payment that historically qualified for relief under the GWE.⁵

GWE's Little-Known Existence

We think most tax practitioners have never heard of the GWE. We know we had not until recently. While tax practitioners may not have known about the existence of the GWE or that it can provide authority to exclude some payments from income, nontax professionals may not be so hamstrung by the cases they read in law or tax school. Indeed, some nontax practitioners we have spoken to thought those types of payments were undoubtedly excludable from gross income, even though they couldn't put their fingers on the legal theory for the exclusion. Perhaps one reason why most tax practitioners are unaware of the existence of the GWE is that virtually all authority that discusses section 61 simply does not mention it.⁶

As we all know, section 61 provides the general rule that gross income includes all income from whatever source derived. Courts have agreed that all income is subject to taxation unless excluded by law.⁷ The position of the IRS is that income is defined as broadly as possible.⁸ Exclusions from income are narrowly construed, and generally have been limited to those specified in the code.⁹ With such an inauspicious foundation, it is almost surprising to find that the IRS has recognized the GWE as an uncodified exclusion from income.

Under the GWE doctrine, the IRS has ruled that payments made under legislatively provided social benefit programs for promotion of the general welfare are

¹*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Vincent v. Commissioner*, T.C. Memo. 2005-95, Doc 2005-9343, 2005 TNT 85-6.

²*Cesarini v. U.S.*, 296 F. Supp.3d (N.D. Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir. 1970); Treas. reg. section 1.61-14.

³348 U.S. 426 (1955).

⁴A summary of the facts is as follows: *Glenshaw Glass* was engaged in protracted litigation with the Hartford-Empire Company. The parties concluded a settlement by which Hartford paid *Glenshaw* approximately \$800,000. Through a Tax Court-approved allocation, it was determined that \$324,529.94 represented payment of punitive damages. *Glenshaw* did not report the punitive portion of the settlement as income. The commissioner determined a deficiency, claiming the total settlement as taxable.

⁵Many disaster payments have now also been statutorily exempted from income under recently enacted section 139. Rev. Rul. 2003-12, 2003-3 IRB 283, Doc 2002-27748, 2002 TNT 245-6, acknowledges that the GWE doctrine overlaps with the application of section 139 in that both can apply.

⁶See *Vincent v. Commissioner*, *supra* note 1 (section 61 mandates gross income includes all income from whatever sources derived absent a specific statutory exclusion, and no mention of nonstatutory exclusions).

⁷*United States v. Burke*, 504 U.S. 229 (1992).

⁸General Counsel Memorandum 34424.

⁹*O'Gilvie v. U.S.*, 519 U.S. 79, Doc 96-31894, 96 TNT 240-1 (1996); *Commissioner v. Schleier*, 515 U.S. 323, Doc 95-5972, 95 TNT 116-8 (1995).

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excludable from gross income.¹⁰ Not surprisingly, almost all IRS GWE authority contains that very language. While there is little judicial authority on the GWE, it seems that all of it follows the IRS's position.¹¹

The GWE doctrine apparently originated in 1938, when the IRS determined that welfare payments (from the then-recently enacted Social Security Act) could be excluded from gross income.¹² Throughout the ensuing 30 years, the IRS continued to issue opinions on the subject,¹³ and by 1971 the IRS used the word "long-standing" to describe the GWE doctrine.¹⁴

GWE Requirements

As noted above, the GWE requires that payments be made under legislatively provided social benefit programs for the promotion of the general welfare. In determining whether the GWE applies to payments, the IRS requires the payments to be:

1. made from a governmental general welfare fund;
2. for the promotion of the general welfare (that is, on the basis of need rather than to all residents); and
3. not made as payment regarding services.¹⁵

The GWE has generally been limited to individuals who receive governmental payments to help them with their individual needs (for example, housing, education, and basic sustenance expenses).¹⁶ Grant payments that compensate for lost profits or business income (whether to individuals or to businesses) do not qualify for the GWE.¹⁷

Payment Origin

The first prong of the GWE requires that the payment be made from a governmental general welfare fund. It does not seem to matter whether the payments originate from the federal government, a state government, or a county government.¹⁸

That requirement appears relatively straightforward, and there does not appear to be any authority analyzing

it. In extant GWE authorities, the fact that a payment originates in the general welfare fund appears to be assumed (or at least the IRS must believe it is easy to determine), and therefore the first prong is not discussed. That suggests that the determination of whether a payment is made from a governmental general welfare fund is mechanical, and has not been subject to interpretive differences for which taxpayers would need guidance.

Black's Law Dictionary defines the "general fund" as a government's primary operating fund — a state's assets furnishing the means for the support of government and for defraying the legislature's discretionary appropriations. It adds that a general fund is distinguished from assets of a special character, such as trust, escrow, and special-purpose funds.¹⁹

Governmental entities seem to adopt the same definition, though it does seem surprising that there are not more discussions of that point. For example, the federal government notes in its 2005 budget that there are several types of funds. The general fund, "which is the greater part of the budget, record[s] receipts not earmarked by law for a specific purpose" including the proceeds of general borrowing, and the expenditures of that money.²⁰ Other funds exist, including "special funds" which have receipts that are earmarked for a specific purpose; "public enterprise funds," which are revolving funds used for business-like operations with the public; "intragovernmental funds," which are revolving funds used for business-like operations within and between other governmental agencies; and "trust funds," which are for carrying out specific programs according to statute.²¹

State and local governments also address those issues. According to the California Legislative Analyst's Office, the general fund is the "main source of support for state programs" such as education, health and social services, and correctional programs.²² Special funds are used for "specific functions or activities of government designated by law" and differ from general funds that can be spent by the legislature for any purpose. Examples of special funds include transportation funds, public utility commission funds, and local government funds.

The city of San Francisco appears to follow those definitions. It notes that the general fund is San Francisco's "primary operating fund. It accounts for all financial resources of the city except those required to be accounted for in another fund."²³ San Francisco has other distinct funds for specific purposes, such as the Airport Fund, the Municipal Transportation Agency Fund, and

¹⁰See CCA 200021036, *Doc 2000-14946*, 2000 TNT 104-74; LTR 200451022, *Doc 2004-23902*, 2004 TNT 244-53.

¹¹See *Bannon v. Commissioner*, 99 T.C. 59 (1992).

¹²See I.T. 3194, C.B. 1938-1 114, which concluded that lump sum payments made to individuals as Social Security benefits (under section 204(a), Title II of the Social Security Act) are not subject to federal income tax in the hands of the recipients; I.T. 3230, C.B. 1938-2 136, which concluded that payments on account of unemployment paid by a state agency out of funds received from the Federal Unemployment Trust Fund are not subject to federal income tax in the hands of the recipient.

¹³See I.T. 3447, C.B. 1941-1 191; Rev. Rul. 131, 1953-2 C.B. 112; Rev. Rul. 55-652, C.B. 1955-2 21; Rev. Rul. 63-136, 1963-2 C.B. 19.

¹⁴GCM 34506.

¹⁵See CCA 200021036, *supra* note 10.

¹⁶Notice 2003-18, 2003-1 C.B. 699, *Doc 2003-7109*, 2003 TNT 54-18; *Bailey v. Commissioner*, 88 T.C. 1293, 1300-1301 (1987), *acq.* 1989-2 C.B. 1; Rev. Rul. 76-131, 1976-1 C.B. 16.

¹⁷Notice 2003-18, *supra* note 16; *Graff v. Commissioner*, 74 T.C. 743 (1980), *aff'd*, 673 F.2d 784 (5th Cir. 1982); Rev. Rul. 76-75, 1976-1 C.B. 14; Rev. Rul. 73-408, 1973-2 C.B. 15.

¹⁸See LTR 200451022, *supra* note 10, for application of the GWE to payments from the federal government. See CCA

(Footnote continued in next column.)

200021036, *supra* note 10, for application of the GWE to payments from a state government. See *Bailey*, *supra* note 16, for application of the GWE to payment from a county government.

¹⁹See *Black's Law Dictionary*, 7th edition, p. 682 (1999).

²⁰See *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2005*, p. 380, located at <http://www.whitehouse.gov/omb/budget/fy2005>.

²¹*Id.*

²²See the Legislative Analyst's Office, *2005-06 Budget: Perspective and Issues*, located at http://www.lao.ca.gov/analysis_2005/2005_pandi/pandi_05.pdf.

²³For more information, see http://www.sfgov.org/site/uploadedfiles/controller/reports/CAFR/cafr_2004.pdf.

the Water Fund. (Although we have not examined every California county, and only a sampling of other state governments, our research has found consistent results.)

Promotion of General Welfare

The second prong of the GWE requires that the payment be for the promotion of the general welfare. That requirement has produced most of the GWE jurisprudence. As we'll see, the area continues to evolve, suggesting a more expansive exception to gross income than might first seem apparent.

Under that prong, the payment must be for the promotion of the general welfare. That can be a quixotic inquiry. The IRS has consistently ruled that the governmental payments must be made on the basis of need.²⁴ Some authority looks to the payment recipient's income level, presumably as a means of assessing need. For example, in some authority, the GWE applies only to individuals who fall below particular income thresholds. In CCA 200022050, the IRS applied the GWE only to individuals whose income was below 80 percent of the county or metropolitan area median. Nevertheless, it seems most GWE authority does not discuss precise income level thresholds, and appears to base the application of the GWE on the specific needs of individuals.²⁵

The IRS determination of what constitutes a needs-based payment seems to vary depending on the need for which the payment is being made. As noted above, the classic example of a needs-based payment qualifying for exclusion under the GWE is a payment made for disaster relief. In Rev. Rul. 2003-12,²⁶ a state was affected by a flood and part of it was a presidentially declared disaster area.²⁷ The state enacted emergency legislation to provide grants to pay or reimburse medical, temporary housing, and transportation expenses not compensated by insurance. The grants were not intended to indemnify all flood losses or to reimburse for nonessential luxury items.

The IRS ruled that those "reasonable and necessary" payments were excluded from the recipients' gross income under the GWE.²⁸ Notably, the IRS also ruled that the payments qualify for exclusion under recently enacted section 139, noting that the section codifies, but does not supplant, the GWE regarding some disaster payments. Next, the ruling discussed relief payments originating from charities and employers, neither of

which meet the requirements of the GWE, because the payments do not stem from the government. Nonetheless, payments from charities were held to be excludable as gifts and payments from employers were held to be excludable under section 139.²⁹

Many varieties of housing assistance meet the requirements of the GWE. In a series of chief counsel advice, the IRS said some housing payments to flood victims were excludable from income under the GWE. CCA 200022050 concluded that payments made by the state of North Carolina to assist low-income homeowners in replacing, repairing, and rehabilitating flood damaged homes were in the nature of general welfare, and not includable in the homeowner's gross income. State payments to assist home repair by reducing the affected individual's debt burden also qualify under the GWE.³⁰ Similarly, state supplemental payments to enable homeowners to purchase comparable housing outside a flood plain (after a federal program purchased the original flood-damaged house) were not income to the recipients.³¹ Moreover, state payments to enable renters to relocate after the flood were held to be excludable.³²

Not all housing rulings relate to disasters. The IRS has ruled that relocation assistance payments to low-income homeowners in the absence of a flood or other disaster can meet the requirements of the GWE.³³ In Rev. Rul. 76-395,³⁴ the IRS ruled that federally funded home rehabilitation grants received by low-income homeowners residing in a defined area of a city under the city's community development program were in the nature of general welfare and not includable in the recipients' gross incomes. In Rev. Rul. 75-271,³⁵ federally provided mortgage assistance payments to low-income homeowners were not includable in the recipients' income.

Basic sustenance payments have been held to meet the requirements of the GWE. In Rev. Rul. 78-170,³⁶ the state of Ohio provided credits to elderly and disabled persons for payment of their winter energy bills. To qualify, an individual had to be the head of the household, at least 65 years old or permanently disabled, and have a total income under \$7,000. Propane dealers and utility companies were to reduce the amount charged by the amount of credits provided, and the state would reimburse the dealers and utility companies for the credits. The IRS ruled that the amounts paid, directly or indirectly, were

²⁴See CCA 200022050, *Doc 2000-15570*, 2000 TNT 108-67; CCA 200017040, *Doc 2000-12060*, 2000 TNT 84-56; CCA 200016019, *Doc 2000-11659*, 2000 TNT 79-37; CCA 200013031, *Doc 2000-9671*, 2000 TNT 64-54.

²⁵See LTR 200451022, *supra* note 10.

²⁶*Supra* note 5.

²⁷A presidentially declared disaster area is defined in section 1033(h)(3).

²⁸For other disaster related authority, see Rev. Rul. 98-19, 1998-1 C.B. 840, *Doc 98-10448*, 98 TNT 59-9 (relocation payment made by a local government to an individual moving from a flood-damaged residence is not includable in the individual's gross income); Rev. Rul. 76-144, 1976-1 C.B. 17 (grants received by individuals unable to meet necessary expenses or serious needs as a result of a disaster are not includable in the recipient's gross income); Rev. Rul. 75-28, 1975-1 C.B. 68; Rev. Rul. 71-260, 1971-1 C.B. 57.

²⁹Rev. Rul. 2003-12 modified Rev. Rul. 131, which concluded that the GWE applied to disaster payments made by an employer.

³⁰CCA 200016019, *supra* note 24.

³¹CCA 200017040, *supra* note 24.

³²CCA 200013031, *supra* note 24. *But see* Rev. Rul. 82-16, 1982-1 C.B. 16, in which relocation assistance benefits required to be paid to tenants by landlords under a municipal ordinance were determined to be includable in the gross income of the tenant.

³³Rev. Rul. 76-373, 1976-2 C.B. 16; Rev. Rul. 74-205 1974-1 C.B. 20.

³⁴1976-2 C.B. 16.

³⁵1975-2 C.B. 23.

³⁶1978-1 C.B. 24.

relief payments made for the promotion of general welfare and were not includable in the gross income of the recipients.³⁷

Education, Adoption, and Other Needs

What each of us “needs” may be subjective, but clearly for all of us that goes beyond food, water, and shelter. The IRS has applied the GWE in varied contexts. For example, it has ruled that some payments for education are of the type of welfare payment to which the GWE applies.

In LTR 200409033,³⁸ an American Indian tribe made education assistance payments to tribe members. The IRS ruled that the payments made to qualifying tribe members with an income below the national median income level were not includable in income. Payments made to those with income above the national median were includable in income. Notably, the ruling did not provide any explanation why the national median income level was the chosen threshold. However, with that threshold, perhaps most American Indian tribe members would be able to exclude those payments.

The IRS also has determined that some payments to facilitate adoption can qualify for the GWE.³⁹ In Rev. Rul. 74-153,⁴⁰ the state of Maryland provided assistance to adoptive parents who met all state requirements for adoption except the ability to provide financially for the adoptive child. The IRS ruled that the adoption assistance payments met the requirements of the GWE and were excludable from gross income.

Similarly, in CCA 200021036, the IRS reviewed the tax status of payments to adoptive parents of special needs children. The state made the payments to entice potential adoptive parents to adopt special needs children, but only in situations in which it was reasonable to conclude that the children could not be adopted without that assistance. The IRS found that the payments were not includable in income under the GWE, and that the payments were “based on the special needs of the children.”

There are other categories of payments that don’t seem to fit the mold of the majority of authority. For example, some economic development payment grants have met the requirements of the GWE. In LTR 199924026, nonreimbursable economic development grants made by an American Indian tribal nation to eligible members were held to be excludable from income.⁴¹ Another example is Rev. Rul. 74-74,⁴² in which the IRS concluded that payments from the Crime Victims Compensation Board (CVCB) were not income. The ruling held that awards made by the state of New York CVCB to victims of crime or their surviving spouse or dependents were not includ-

able in income. Notably, the amount of the award was based on the financial resources of the recipient.

Payments Not Based on Need

In contrast, payments not based on need do not qualify for the GWE. In Rev. Rul. 76-131,⁴³ the state of Alaska made payments to persons over 65 who had maintained a continuous domicile in Alaska for 25 years regardless of financial status, health, educational background, or employment status. The IRS ruled that the payments were not needs-based and the purpose of making the payments was not for the public benefit.⁴⁴ Consequently, those payments were includable in income. While Rev. Rul. 76-131 is instructive in its ability to demonstrate when payments are not needs-based, it does not appear to have dampened subsequent positive GWE authority.

Although it may appear that all payments under the GWE must be based on economic need, the IRS has ruled on occasion that payments meet the requirements of the GWE (and are not includable in income) even if the payments were not completely based on economic need. Authority supporting that position, however, is rare. For example, Rev. Rul. 57-102⁴⁵ may be one of the only authorities applying the GWE to payments that were not based on economic need. The IRS there ruled that government payments made to blind persons (solely because of their visual disability) were excludable from gross income. Because of the age of that ruling and the lack of any subsequent authority following its rationale, taxpayers might not want to place too much support on it.

There is at least one modern authority in which the IRS equivocated on the extent of the need required under the second prong of the GWE. In CCA 200114044,⁴⁶ the IRS reviewed payments made by FEMA to victims of the Cerro Grande fire in New Mexico (which was started by a park ranger). The IRS ruled that payments from private insurance companies to persons who were privately insured were excluded from income under section 123. Payments from FEMA to persons who were insured through FEMA were also excluded from income under section 123.

Payments from FEMA to underinsured and noninsured persons presented a more interesting question. Because claimants had to waive their rights to file a claim against the government to receive payments, the IRS believed the FEMA payments were best viewed as a substitute for judgment. However, the IRS acknowledged that a court might find that the payments met the requirement of the GWE. The IRS advised its agents not to pursue the matter at all — essentially equivocating on whether the GWE applied. Thus, the IRS realized that the GWE might apply when economic need was not the primary issue. Nevertheless, the CCA advised agents to pursue the payments as taxable if IRS employees determined that payments were used for luxuries.

³⁷Cf. Rev. Rul. 79-142, 1979-1 C.B. 58, and GCM 37781 regarding day-care facility owners providing food to needy children.

³⁸Doc 2004-3963, 2004 TNT 40-26.

³⁹Section 137 excludes some adoption expenses. See Sheldon R. Smith, “The Tax Exclusion for Adopting Children With Special Needs,” *Tax Notes*, Aug. 22, 2005, p. 925.

⁴⁰1974-1 C.B. 20.

⁴¹See also Rev. Rul. 77-77, 1977-1 C.B. 11.

⁴²1974-1 C.B. 18.

⁴³1976-1 C.B. 16.

⁴⁴See also LTR 9717007, Doc 97-11607, 97 TNT 81-9; Rev. Rul. 73-408, 1973-2 C.B. 15.

⁴⁵1957-1 C.B. 26.

⁴⁶Doc 2001-9989, 2001 TNT 68-54.

CCA 200114044 thus represents one of the more interesting pieces of GWE lore. It suggests that there is a sensitivity on the part of the IRS about the potential reach of the GWE, and yet a reluctance to thoroughly vet the issue. At the same time, the IRS implicitly seems to recognize the fuzzy gray line between necessities and luxuries. If that line must be crystallized, after all, it would seem to invite factual fistfights.

Payments to Others

In some situations, government payments do not go directly to the person in need of assistance. Rather, parents or legal guardians may receive the payments on behalf of others. The IRS has ruled that the applicability of the GWE does not hinge whether some portion of the payment goes to another, albeit related, person, as opposed to being made directly to the affected individual. In CCA 200021036 discussed above, the IRS expressly noted that payments for the benefit of special needs children could be made directly to the parents without affecting the application of the GWE. The IRS noted that "because the payments are intended to reimburse the parents' expenses of promoting the health and well-being of these special needs children, the interposition of the parents as recipients of the payments does not preclude the application of the GWE."⁴⁷

Reimbursements

Frequently, taxpayers receive government payments only after the fact, as reimbursement of prior expenses. The IRS has ruled that applicability of the GWE does not depend whether some of the amounts received may in fact be reimbursements. In LTR 200451022,⁴⁸ a nonprofit was organized to provide services to the developmentally disabled. The organization requested an IRS private ruling on whether some reimbursements were taxable.

The nonprofit was a regional center that provided items needed by developmentally disabled persons, such as day care, diapers, nutritional supplies, and so forth. Family members sometimes purchased the items and obtained reimbursement from the regional centers. The amount of reimbursement was based on a sliding scale in accordance with the family's economic need. The IRS ruled that the nonprofit met all three requirements of the GWE, so that the payments were excludable from the recipients' income. That ruling suggests that taxpayers who have already personally expended funds could still benefit from the GWE, because reimbursement should not affect the GWE's applicability.

When payments are received as reimbursements, it must be determined how the taxpayer previously treated the cost for which reimbursement has been provided. For example, it would be common for a taxpayer to deduct under section 165 any losses sustained if his house were destroyed in a natural disaster. The tax benefit rule could require individuals who claimed a deduction to later include a corresponding amount in income if the indi-

vidual receives government grants.⁴⁹ Essentially, the tax benefit rule prevents taxpayers from getting a double benefit.

Services Not Allowed

The third prong of the GWE requires that payments cannot be made for services performed.⁵⁰ Payments for services constitute taxable income.⁵¹ That axiom is well illustrated in CCA 200227003.⁵² The state of Massachusetts had a program under which its senior citizens received property tax abatements for performing voluntary community service. The IRS found that those payments were includable in the seniors' incomes because the seniors had to perform services to receive the payments. The CCA also noted that the payments did not meet the second requirement of the GWE, that the payments be based on need. According to the CCA, age is not a demonstrated need.

Although the courts have rarely undertaken a review of the GWE, they have followed the IRS's position. For example, in *Bannon v. Commissioner*,⁵³ the taxpayer received money from the San Joaquin County Human Resources Agency for taking care of her mentally retarded adult daughter. Those services could have been (and sometimes were) provided by third parties. The court held the payments to be includable in the mother's income. On the other hand, the IRS conceded that government payments made directly to the disabled daughter that were to provide in-home support services to her, as a disabled citizen, were not includable in gross income.⁵⁴

One area of the GWE that historically has been subject to special scrutiny is welfare benefits. Although welfare benefits are the genesis of the GWE doctrine, that area has provided considerable GWE authority over the years. Generally, payments for unemployment compensation have met the requirements of the GWE.⁵⁵ Nevertheless, confusion arose from legislation enacted in many states under which recipients of unemployment benefits were required to perform some level of services to receive their benefits.

As noted above, the requirement that a person provide services will disqualify the payment from meeting the requirements of the GWE. The performance of training by the welfare recipient, on the other hand, is allowed under the GWE. Thus, the application of the GWE to welfare benefits seems to be based on whether the activity required to be performed is more in the nature of

⁴⁹See *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983); CCA 200016019, *supra* note 24.

⁵⁰CCA 200227003, *Doc 2002-15743*, 2002 TNT 130-22.

⁵¹*U.S. v. Dieter*, 2003 U.S. Dist. Lexis 6391; 91 AFTR2d 1891, *Doc 2003-15194*, 2003 TNT 124-11.

⁵²*Doc 2002-15743*, 2002 TNT 130-22.

⁵³99 T.C. 59 (1992).

⁵⁴See also *May v. Commissioner*, T.C. Memo. 1993-86, *Doc 93-3373*, 93 TNT 60-7; *Meyer v. Commissioner*, T.C. Memo. 1994-536, *Doc 94-9701*, 94 TNT 210-8; *Baldwin v. Commissioner*, T.C. Memo. 2000-306, *Doc 2000-24896*, 2000 TNT 189-5.

⁵⁵Notice 99-3, *Doc 98-37285*, 98 TNT 243-8; Rev. Rul. 76-229, 1976-1 C.B. 19.

⁴⁷See also LTR 200451022, *supra* note 10; Rev. Rul. 74-153, *supra* note 40.

⁴⁸*Doc 2004-23902*, 2004 TNT 244-53.

training than in the nature of services. Consequently, vocational and occupational training provided by recipients designed to upgrade basic skills (such as remedial education) should not cause the benefits provided to fail to come within the GWE.⁵⁶

The GWE has also been applied to payments to work-training participants when the payments were made by the state welfare agency, based on need, and not for the value of the services performed.⁵⁷ In contrast, if the training is on-the-job experience, payments may be includable in income, depending on the degree of control exercised by the de facto employer over the recipient of public benefits. Control by the de facto employer (as opposed to control by the welfare agency) makes the training seem more like a typical employer-employee relationship, thus suggesting that the payments should be includable in income.⁵⁸ Moreover, if the training is just ancillary or if there is no training at all, the relationship looks far more like a typical employment relationship and the payment should be includable in income.⁵⁹

Applicability of GWE Under California Tax Law

Readers not from California will have to bear with us for a moment. We present here our thoughts on the application of the GWE under California tax law because we are from California. Unfortunately, we are unable to comment on how other states might react (or have reacted) to the GWE. Of course, we would be glad to hear from readers on their own research into states besides California.

In our adventures into the GWE, we have found no clear authority bearing on whether California conforms (or would conform) to the GWE. Nevertheless, there are several indications that California might conform to the GWE if presented the opportunity, or at least would reach similar results even if it did not expressly conform. First, for tax years after January 1, 2002, California has incorporated the Internal Revenue Code as it existed on January 1, 2001, into the California Revenue and Taxation Code.⁶⁰ Although we understand that a bill is currently proceeding through the state Legislature that would conform California law to the IRC as of January 1, 2005, the eventual passage of that bill does not seem to affect our analysis.

Full federal statutory conformity would be helpful of course, but it is clear that the GWE has not been incorporated into the IRC. The GWE is an administrative exclusion, the application of which is subject to IRS discretion. Thus, incorporation of the code into the California Revenue and Taxation Code may not be sufficient to determine how the California taxing authorities would apply the GWE. The same would presumably be true for other states.

Recognizing the inherent limitations of incorporating only the federal tax code, California also incorporates other "uncodified provisions that relate to provisions of the Internal Revenue Code."⁶¹ Although the term "uncodified provisions" is not defined in the California Revenue and Taxation Code, it may refer to IRS administrative pronouncements, such as revenue rulings, revenue procedures, general counsel memorandums, chief counsel advice, and the like. If that interpretation is correct, California has statutorily adopted all prior IRS GWE rulings.

It goes without saying that even if California has effectively adopted all prior federal administrative authorities, that would not be dispositive on the application of the GWE in California to any new scenario on which no federal authority already existed on a particular set of facts. Even so, it is worth noting that this interpretation of the California statute provides support that California should follow the federal position. California has adopted other federal nonstatutory income tax doctrines, including the assignment of income doctrine⁶² and the step transaction doctrine.⁶³

The California Revenue and Taxation Code expressly provides that IRC section 61, defining gross income, shall apply unless otherwise provided.⁶⁴ That suggests that items that are included in gross income for federal income tax purposes would also be included for California income tax purposes, unless California law provides otherwise. Commerce Clearing House, in its annual *Guidebook to California Taxes*, notes that "the same items are included under both [federal and California] laws, unless a specific exception [in California law] is spelled out."⁶⁵

The California Revenue and Taxation Code does not discuss the GWE. That omission suggests that items excluded under the GWE for federal income tax purposes may also be excluded for California income tax purposes. Nevertheless, California's taxing authorities could argue that the GWE does not apply because California law expressly incorporates only IRC section 61 and does not incorporate nonstatutory exceptions to section 61. Because the GWE is not part of the IRC, the California authorities could certainly argue that it has not been incorporated into California law.

Virtually no California judicial or administrative authority exists on the GWE. In 1975 the California Franchise Tax Board (FTB) issued a legal ruling that acknowledged the existence of the GWE, but the ruling did not comment on it.⁶⁶ The ruling discussed the qualified

⁵⁶Rev. Rul. 75-246, 1975-1 C.B. 24; Rev. Rul. 63-136 1963-2 C.B. 19.

⁵⁷Rev. Rul. 71-425, 1971-2 C.B. 76.

⁵⁸Rev. Rul. 75-246, *supra* note 56.

⁵⁹Rev. Rul. 65-139, 1965-1 C.B. 31, *clarified by* Rev. Rul. 66-240, 1966-2 C.B. 19; Rev. Rul. 74-413, 1974-2 C.B. 333.

⁶⁰California Revenue and Taxation Code section 17024.5(a)(1) (M).

⁶¹California Revenue and Taxation Code section 17024.5(a)(2).

⁶²*See In the Matter of the Appeal of Hans F. and M. Milo*, 1981 Cal. Tax LEXIS 89; *Meanley v. McColgan*, 49 Cal. App.2d 203 (1942). *Cf.* SBE Rulings 2002 Cal. Tax. Lexis 454 and 2000 Cal. Tax Lexis 134.

⁶³*See McMillin BCED/Miramar Ranch North v. County of San Diego*, 31 Cal. App. 4th 515 (1995).

⁶⁴California Revenue and Taxation Code section 17071.

⁶⁵Bock, *2005 Guidebook to California Taxes*, CCH (2005).

⁶⁶Legal Ruling No. 380, 1975 Cal. FTB Lexis 1.

renters' credit, which granted a credit against state income tax and a refund for the amount of the unused credit. The ruling says the refund is not included in gross income because it is "consistent with the long-standing judicial practice" of construing tax relief measures in favor of the intended beneficiaries.

The FTB's brief and somewhat cryptic ruling does not provide much guidance on the GWE. The ruling says its result is consistent with IRS policy under the GWE. Unfortunately, though, the ruling does not indicate whether the FTB is following the GWE, nor does it provide any indication of the FTB's position on the GWE.

There is another piece of California authority that discusses the GWE.⁶⁷ It is a California State Board of Equalization (SBE) determination that expressly notes that it cannot be cited as precedent. Nonetheless, it is helpful in determining the SBE's position on the GWE.

The SBE determination discusses a 1998 examination of whether a taxpayer could file as head of household when her adult daughter and infant granddaughter lived with her. To file as head of household, the taxpayer needed to claim her daughter as a dependent. The daughter had received AFDC (Aid to Families with Dependent Children) government payments, and it was uncertain if those payments were gross income to her. If the payments were gross income, the daughter would have had too much income to be classified as a dependent of the taxpayer.

The SBE noted that the recipient of AFDC payments was the granddaughter, so the payments were not income to the daughter. While that conclusion alone was sufficient to make a determination that the taxpayer could file as head of household, significantly, the ruling continued, noting:

even if the benefits were to appellant's daughter, it appears that the benefits would not be included in appellant's daughter's gross income. . . . The courts have acknowledged the existence of the general welfare doctrine of income exclusion. *Bannon v. Commissioner* 99 T.C. 60 (1992). Generally, government disbursements promoting the general welfare are not taxable.

The SBE's acknowledgment that the U.S. Tax Court upheld the GWE is helpful, as is its statement that "generally, government disbursements promoting the general welfare are not taxable." However, neither of those California authorities seem dispositive that California would definitively uphold the GWE. Nonetheless, taking into account those few authorities and the general principles of California income taxation, it does seem that California may conform, or that at least it should, we

would hope, reach results similar to the GWE. Unfortunately, as any reader who has spent time fighting California tax cases knows, the Golden State has more than its fair share of uncertainties and surprises.

Conclusions

The GWE is a relatively unknown income exclusion doctrine that paradoxically has been around for almost 70 years. As such, it is surprising how it continues to fly under the radar of many tax practitioners. The doctrine and the policy behind it seem simple: It doesn't make sense for the government to tax government-provided assistance payments. Yet, given how few and far between exemptions from income are, the GWE merits a closer look.

Although the GWE originated as a simple idea, it has been expanded to all sorts of government payments, ranging from disaster payments to housing, education, adoption, and even crime victim restitution. Curiosity makes us wonder whether the IRS will continue to expand the GWE's reach. The government makes billions of dollars of payments to taxpayers annually based on general welfare. That suggests some tax planners may be missing an opportunity here.

Creative tax planners may consider their own doctrinal exploration. Could the GWE apply to payments from the government that the taxpayer receives only after suing? Stated differently, if there is a government welfare benefit, should the applicability of the GWE hinge on whether the benefit is voluntarily provided? That kind of inquiry is worth making. Although lawsuits based on government programs (such as health, education, and welfare) may be rare, an exclusion from income is rare too, and is worth including on a mental checklist.

There are other questions that approach the doctrine. How can one police the line between necessities and luxuries? If the governmental agency and the taxpayer agree what constitutes "necessities" (say, a 2,000 square foot house), will that bind the IRS? Will it even influence the IRS?

Regardless of future doctrinal expansion, practitioners who do not explore the GWE may be overlooking a valuable tool in their tax reduction arsenal. It is possible that some taxpayers (and practitioners) have reached results consistent with the GWE on some fundamental "gee, this *can't* be taxable" theory. However, there is probably a larger segment of taxpayers and tax advisers who conclude that payments are includable in income, when in fact the GWE could arguably be applied.

Thankfully, even in this era of tax practitioner scrutiny, in which Circular 230 legends and lawsuits seem to abound, there does not (yet) appear to be any authority suggesting that ignorance of the GWE is malpractice. Still, we would all do well as a group to consider the GWE in appropriate cases.

⁶⁷1998 Cal. Tax Lexis 341.