

General Welfare Exclusion Can Mean Tax-Free Money

By Robert W. Wood & Richard C. Morris¹

Most people know that the Internal Revenue Code (“IRC” or the “Code”) casts a wide net. Gross income for tax purposes includes just about everything. According to the courts, this wide net subsumes income from every source, including wages, gains, prizes – even “treasure trove” (whether buried or not).² So, a million dollars found inside a piano is includible in income to the lucky finder.³ So is that \$20 bill you found on the street – never mind that the person who lost the money probably cannot claim a deduction. Who said tax is fair?

Code §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.⁴ The position of the Internal Revenue Service (“IRS” or the “Service”) is that income is defined as broadly as possible.⁵ Exclusions from income are narrowly construed, and generally have been limited to those specified in the Code.⁶

Tax practitioners routinely profess that it seems that virtually everything constitutes income for tax purposes. No wonder it appears that the breadth of the gross income concept is nearly limitless. Nevertheless, a little known administrative exception exists that eludes the gross income net. It is called the general welfare exception (“GWE”).

Under the GWE, certain government payments do not constitute gross income to the recipients. 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 Service has not ruled on this particular issue, payments made by the Federal Emergency Management Agency (“FEMA”) to hurricanes victims are of the

type of payment that historically qualified for relief under the GWE.⁷

I. GWE REQUIREMENTS

The GWE requires that payments be made under legislatively provided for social benefit programs for the promotion of the general welfare.⁸ 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 (i.e., on the basis of need rather than to all residents); and (3) not made as payment with respect to services.⁹

The GWE has generally been limited to individuals who receive governmental payments to help them with their individual needs (e.g., housing, education, and basic sustenance expenses).¹⁰ Payments that compensate for lost profits or business income (whether to individuals or businesses) do not qualify for the GWE.¹¹

A. Payment Origin

The first prong of the GWE requires that the payment be made from a governmental general welfare fund.¹² It does not seem to matter whether these payments originate from the federal government, a state government or a county government.¹³ This requirement appears to be relatively straightforward, and there does not appear to be any authority that analyzes 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 that it is easy to determine), and therefore this first prong is not addressed. This 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.

B. Promotion of General Welfare

The second prong of the GWE requires that the payment be for the promotion of the general welfare. This can be a Quixotic inquiry and has produced the vast majority of the GWE jurisprudence. As we will see, this area continues to evolve, suggesting a more expansive exception to gross income than might first seem apparent.

The Service has consistently ruled that the governmental payments must be made on the basis of need. Although some authority looks to the payment recipient’s income level, presumably as a means of assessing need,¹⁴ most GWE authority does not discuss precise income level thresholds, and appears to base the application of the GWE on the particular needs of individuals.¹⁵

The Service’s determination of what constitutes a needs-based payment varies 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 Revenue Ruling 2003-12, a state affected by a flood was Presidentially-declared a disaster area.¹⁶ 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 non-essential, luxury items. The Service ruled that these “reasonable and necessary” payments were excluded from the recipient’s gross income under the GWE.¹⁷

Many types of housing assistance can meet the requirements of the GWE. In a series of Chief Counsel Advices (“CCA”), the IRS ruled that certain housing

payments to flood victims were excludable from income under the GWE. In CCA 200022050 state payments to assist low-income homeowners in replacing, repairing and rehabilitating flood damaged homes were in the nature of general welfare, and not includible 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.¹⁸ 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.¹⁹ Moreover, state payments to enable renters to relocate after the flood were held to be excludable.²⁰

Not all housing rulings relate to disasters. The Service 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.²¹ In Revenue Ruling 76-395, the Service 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 includible in the recipients' gross incomes.²² In Revenue Ruling 75-271, federally provided mortgage assistance payments to low-income homeowners were not includible in the recipient's income.²³

Basic sustenance payments have been held to meet the requirements of the GWE. In Revenue Ruling 78-170,²⁴ 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 Service ruled that the amounts paid, directly or indirectly, were relief payments made for the promotion of general welfare and were not includible

in the gross income of the recipients.²⁵

1. 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 Service has applied the GWE in varied contexts. Thus, the Service has ruled that certain payments for education are of the type of welfare payment to which the GWE applies.

In Private Letter Ruling ("PLR") 200409033, a Native American Tribe made education assistance payments to tribe members. The Service ruled that the payments made to qualifying tribe members with an income below the national median income level were not includible in income. Payments made to those with income above the national median were includible in income. Notably, the PLR did not provide any explanation as to why the national median income level was the chosen threshold. However, with that threshold, perhaps most Native American Tribe members would be able to exclude such payments.

The Service has also determined that certain payments to facilitate adoption can qualify for the GWE.²⁶ In Revenue Ruling 74-153,²⁷ 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 Service ruled that the adoption assistance payments met the requirements of the GWE and were excludable from gross income. Similarly, in CCA 200021036, the Service 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 where it was reasonable to conclude that such children could not be adopted without such assistance. The Service found that the payments were not includible in income under the GWE, and that such payments were "based on the special needs of the children." Interestingly, in this context, the Service has expressly ruled that the payments did not need to be paid directly to the person in need (i.e., the child), but could be paid to the adoptive parent or

legal guardian.²⁸

There are other categories of payments that do not seem to fit the mold of the majority of authority. For example, certain economic development payment grants have met the requirements of the GWE. In PLR 199924026, non-reimbursable economic development grants made by a Native American tribal nation to eligible members were held to be excludable from income.²⁹ Another example is Revenue Ruling 74-74, where the Service held that payments from the Crime Victims Compensation Board ("CVCB") were not income.³⁰ Specifically, the Service ruled that awards made by the state of New York CVCB to victims of crime or their surviving spouse or dependents were not includible in income. Notably, the amount of the award was based on the financial resources of the recipient.

2. Payments Not Based on Need

In contrast, payments that are not based on need do not qualify for the GWE. In Revenue Ruling 76-131, the state of Alaska made payments to persons over 65 years old who had maintained a continuous domicile in Alaska for 25 years regardless of financial status, health, educational background or employment status.³¹ The Service ruled that the payments were not need-based and the purpose of making the payments was not for the public benefit.³² Consequently, these payments were includible in income. While Revenue Ruling 76-131 is instructive in its ability to demonstrate when payments are not need-based, it does not appear to have dampened subsequent positive GWE authority.

C. Services Not Allowed

The third prong of the GWE requires that payments cannot be made with respect to services performed.³³ Payments for services constitute taxable income.³⁴ This axiom is well illustrated in CCA 200227003, where the state of Massachusetts had a program under which its senior citizens received property tax abatements for performing voluntary community service. The Service found that these payments were includible in the seniors' incomes since the seniors had to

perform services to receive the payments. The CCA also noted that these 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, when they have reviewed it, they have followed the Service's position. For example, in *Bannon v. Commissioner*, the taxpayer received money from the San Joaquin County Human Resources Agency for taking care of her mentally retarded adult daughter.³⁵ These services could have been – and sometimes were – provided by third parties. The court held these payments to be includible in the mother's income. On the other hand, the Service 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 includible in gross income.³⁶

II. REIMBURSEMENTS

Frequently, taxpayers receive certain government payments only after the fact, as reimbursement of prior expenses. The Service has ruled that the applicability of the GWE does not depend on the fact that some of the amounts received may in fact be reimbursements. In PLR 200451022, a non-profit that provided services to the developmentally disabled reimbursed family members who purchased certain necessary items. Notably, the amount of reimbursement was based on a sliding scale in accordance with the family's economic need. The Service ruled that the non-profit met all three requirements of the GWE, so that the payments were excludable from the recipients' income.

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 IRC §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 individual receives

government grants.³⁷ Essentially, the tax benefit rule prevents taxpayers from getting a double benefit.

III. FINAL THOUGHTS

The GWE is a relatively unknown income exclusion doctrine that continues to fly under the radar of even most tax practitioners. The doctrine and the policy behind it seem simple: it does not 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.

The GWE has been applied to all sorts of government payments, ranging from disaster payments to housing, education, and adoption, even crime victim restitution. Curiosity makes me wonder whether the Service will continue to expand the GWE's reach. The government makes billions of dollars of payments to taxpayers annually based upon 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 governmental welfare benefit, should the applicability of the GWE hinge on whether the benefit is voluntarily provided? This kind of inquiry is worth making. Although lawsuits based on governmental programs (e.g., health, education and welfare) may be rare, an exclusion from income is rare too, and is worth including on a mental checklist.

Regardless of future doctrinal expansion, practitioners who do not explore the GWE may be missing a valuable tool found within 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 are probably a larger segment of taxpayers and tax advisers who conclude that payments are includible in income, when in fact the GWE could arguably be applied.

Thankfully, even in this era of tax practitioner scrutiny, where Circular 230

legends and lawsuits seem to abound, there does not (yet) appear to be any authority that suggests that ignorance of the GWE is malpractice. Still, we would all do well as a group to consider the GWE in appropriate cases.

ENDNOTES

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2. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Vincent v. Comm'r*, T.C. Memo. 2005-95.

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

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

5. Gen. Couns. Mem. ("GCM") 34424.

6. *O'Gilvie v. United States*, 519 U.S. 79 (1996); *Commissioner v. Schleier*, 515 U.S. 323 (1995).

7. Many disaster payments have now also been statutorily exempted from income under recently enacted §139. Rev. Rul. 2003-12, 2003-3 I.R.B. 283, acknowledges that the GWE doctrine overlaps with the application of §139 in that both can apply.

8. See CCA 200021036; PLR 200451022.

9. See CCA 200021036.

10. Notice 2003-18, 2003-1, C.B. 699.

11. *Id.*

12. *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 notes that a general fund is distinguished from assets of a special character, such as trust, escrow and special-purpose funds. *Black's Law Dictionary*, 7th edition, p. 682 (1999).

13. See PLR 200451022 for the application of the GWE to payment from the federal government. See CCA 200021036 for the application of the GWE to payment from a state government. See *Bannon v. Commissioner*, 99 T.C. 59 (1992) for the application of the GWE to payment from a county government.

14. See CCA 200002050.

15. See PLR 200451022.

16. 2003-3 I.R.B. 283.

17. Relief payments originating from charities and employers do not meet the requirements of the GWE, since the payments do not stem from the government. Nonetheless, payments from charities could be excludable as gifts and payments from employers could be excludable under §139.

18. CCA 200016019.

19. CCA 200017040.

20. CCA 200013031. 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 includible in the gross income of the tenant.

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

22. 1976-2 C.B. 16.

23. 1975-2 C.B. 23.

24. 1978-1 C.B. 24.

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

26. I.R.C. §137 excludes certain adoption expenses. See Sheldon R. Smith, *Tax Exclusion for Adopting Children with Special Needs*, *TAX NOTES* (Aug. 22, 2005), Vol. 108, n. 9.

27. 1974-1 C.B. 20.

28. See also PLR 200451022; Rev. Rul. 74-153.

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

30. 1974-1 C.B. 18.

31. 1976-1 C.B. 16.

32. See also PLR 9717007; Rev. Rul. 73-408, 1973-2 C.B. 15.

33. CCA 200227003.

34. *U.S. v. Dieter*, 2003 U.S. Dist. Lexis 6391; 91 A.F.T.R.2d 1891.

35. 99 T.C. 59 (1992).

36. See also *May v. Comm'r*, T.C. Memo. 1993-86; *Meyer v. Comm'r*, T.C. Memo. 1994-536; *Baldwin v. Comm'r*, T.C. Memo. 2000-306.

37. See *Hillsboro National Bank v. Comm'r*, 460 U.S. 370 (1983); CCA 200016019.