

The GWE, a (Not So New) Tax Exclusion Worth a Look

Under the general welfare exception (GWE), certain payments of social benefit programs are excluded from income. This article describes the GWE requirements and the kinds of payments covered.

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Executive Summary

- Under the GWE, certain governmental payments, such as payments to natural disaster victims, do not constitute gross income.
- The GWE is generally limited to individuals who receive governmental payments for their individual needs.
- The GWE does not apply to payments for a recipient's performance of services.

Most people know that the Internal Revenue Code casts a wide net. For example, under Sec. 61, gross income for tax purposes includes just about everything. According to the courts, this net subsumes income from every source, including wages, gains, prizes—even treasure trove (whether buried or not).¹ A million dollars found inside a piano is includible in the income of the lucky finder.² So is \$20 found on the street; never mind that the person who lost the money probably cannot claim a deduction. Who said tax is fair?

Courts have agreed that all income is subject to taxation unless excluded by law.³ Income is defined as broadly as possible by the IRS.⁴ Exclusions from income are narrowly construed and generally have been limited to those specified in the Code.⁵ Nevertheless, a little known administrative exception exists, which eludes the gross income net. It is called the general welfare exception (GWE). This article describes the kinds of government payments that can qualify for the GWE.

GWE

Under the GWE, certain government payments do not constitute gross income to the recipients. The GWE doctrine has been applied by the IRS 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 hurricane victims are of the type of payment that historically qualified for relief under the GWE.⁶

Requirements

The GWE requires the payments to be made under legislatively provided social benefit programs for the promotion of the general welfare.⁷ 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.⁸

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).⁹ Payments that compensate for lost profits or business income (whether to individuals or businesses) do not qualify for the GWE.¹⁰

Payment Origin

The first prong of the GWE requires payments to be made from a governmental general welfare fund.¹¹ What does not seem to matter is whether these payments originate from the Federal, state or a county government.¹²

The first requirement appears to be relatively straightforward, and there does not seem 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 generally assumed (or

at least the IRS must believe that this would be easy to verify), and thus this first prong is not discussed. 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 that would require guidance.

Promotion of General Welfare

The second prong of the GWE requires that the payments promote the general welfare. This can be a Quixotic inquiry and has produced the vast majority of the GWE jurisprudence. 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.¹³ As a means of assessing need, some authority looks to the payment recipient's income level. For example, in some authority, the GWE applies only to individuals who fall below certain income thresholds. In one ruling,¹⁴ the income had to be below 80% of the county or metropolitan area median. Nevertheless, most GWE authority appears not to discuss precise income thresholds, and seems to rely on the particular needs of individuals.¹⁵

The IRS's determination of what constitutes a needs-based payment varies depending on the need. 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. 2003-12,¹⁶ a state was affected by a flood that was a Presidentially declared disaster area.¹⁷ The state enacted emergency legislation to provide grants to pay or reimburse medical expenses, temporary housing and transportation expenses not compensated by insurance. The grants were not intended to indemnify all flood losses nor to reimburse nonessential luxury items.

The Service ruled¹⁸ that these "reasonable and necessary" payments were excluded from the recipient's gross income under the GWE. Notably, it also ruled that these payments qualify for exclusion under recently enacted Sec. 139, stating that the section codifies but does not supplant the GWE as to certain disaster payments. Next, the ruling discusses relief payments originating from charities and employers, neither of which meet the GWE requirements because the payments do not stem from the government. Nonetheless, payments from charities were held to be excludible as gifts, and payments from employers were held to be excludible under Sec. 139.¹⁹

Many types of housing assistance can meet the GWE requirements. In a series of Chief Counsel Advices (CCAs), the IRS ruled that certain housing payments to flood victims were excludible from income under the GWE. One such CCA²⁰ provided that 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 an individual's debt burden also qualify under the GWE.²¹ 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.²² Moreover, state payments to enable renters to relocate after a flood were held to be excludible.²³ Not all housing rulings relate to disasters. For example, the Service ruled that relocation assistance payments to low-income homeowners in the absence of a flood or other disaster can meet the GWE requirements.²⁴ In Rev. Rul. 76-395,²⁵ 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 income. In Rev. Rul. 75-271,²⁶ Federally provided mortgage assistance payments to low-income homeowners were not includible in the recipient's income.

Basic sustenance payments have been held to meet the GWE requirements. In Rev. Rul. 78-170,²⁷ 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 charges by the credits, and the state would reimburse the energy providers for the credits. In the ruling, the amounts paid, directly or indirectly, were relief payments made for the promotion of general welfare and were not includible in the gross income.²⁸

Education, adoption and other needs: What each individual "needs" may be subjective, but clearly it goes beyond food, water and shelter. Thus, the Service has applied the GWE in various contexts. It has ruled, for example, that certain payments for education are of the type of welfare payment to which the GWE applies.

In a letter ruling,²⁹ 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 ruling did not provide any explanation as to why the national median income level was the chosen threshold. However, with that threshold, perhaps most of the tribe members would be able to exclude such payments.

The Service has determined that certain payments to facilitate adoption can qualify for the GWE.³⁰ In Rev. Rul. 74-153,³¹ 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 GWE requirements and were excludible from gross income.

Similarly, in a CCA,³² the Service reviewed the tax status of payments made by a state to adoptive parents of special needs children. The payments were made 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.”

There are other categories of payments that do not seem to fit the mold of most authority. For example, certain payments for economic development grants have met the GWE requirements. In a letter ruling,³³ nonreimbursable economic development grants made by a Native American tribal nation to eligible members were held to be excludible from income.³⁴ In another example,³⁵ the Service held that payments from the Crime Victims Compensation Board (CVCB) were not income. Specifically, 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 recipient’s financial resources.

Payments not based on need: In contrast, payments not based on need do not qualify for the GWE. In Rev. Rul. 76-131,³⁶ the state of Alaska made payments to persons over 65 years old who had maintained a continuous domicile in that state for 25 years regardless of their financial status, health, educational background or employment status. The Service ruled that the payments were not needs-based and their purpose was not for the public benefit.³⁷ Consequently, these payments were includible 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 seem that all payments under the GWE must be based on economic need, the Service has ruled on occasion that payments meet the GWE requirements (and are not includible in income) even if that was not completely the case. Authority supporting this position, however, is rare. For example, Rev. Rul. 57-102³⁸ may be one of the only authorities in which the GWE has been applied to payments that were not based on economic need. The Service ruled that government payments made to blind persons (solely because of their visual disability) were excludible from gross income. Due to the age of this ruling and the lack of any subsequent authority following this rationale, taxpayers arguably may not want to rely too much on it.

There is at least one modern authority in which the Service equivocated on the extent of the need required under the second prong of the GWE. In CCA 200114044,³⁹ the Service reviewed payments made by FEMA to victims of the Cerro Grande fire in New Mexico (which was started by a park ranger). The Service ruled that payments from private insurance companies to persons who were privately insured were excludible from income under Sec. 123. Payments from FEMA to persons who were insured through FEMA were also excluded from income under Sec. 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 Service thought the FEMA payments were best viewed as a substitute for judgment. However, it acknowledged that a court might find the payments met the GWE requirements. The IRS advised its agents not to pursue the matter at all—essentially equivocating on the decision whether the GWE applied. Thus, it realized that the GWE might apply when

economic need was not the primary issue. Nevertheless, CCA 200114044 advised agents to pursue the payments as taxable, if IRS employees determined that payments were used for luxuries. This CCA represents one of the more interesting pieces of GWE lore. It suggests a sensitivity on the part of the Service about the potential reach of the GWE, and yet a reluctance to thoroughly vet the issue. At the same time, the Service 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 fist fights.

Payments to others: In certain 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 Service has ruled⁴⁰ that the applicability of the GWE does not hinge on the fact that some portion of the payment goes to another, albeit a related person, as opposed to the affected individual directly. For example, in CCA 200021036,⁴¹ 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. Accordingly, “[b]ecause 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.”

Reimbursements: Frequently, taxpayers receive certain government payments only after the fact, as reimbursement of prior expenses. For example, the Service has ruled⁴² that whether the GWE applies does not depend on the fact that some of the amounts received may in fact be reimbursements. In the ruling, a nonprofit was organized to provide services to the developmentally disabled. This nonprofit was a regional center that provided certain items needed by developmentally disabled persons, such as day-care, diapers, nutritional supplies, etc. These items were purchased by family members sometimes; who then obtained reimbursement from the regional center. The amount of reimbursement was based on a sliding scale in accordance with the family’s economic need. According to the ruling, the nonprofit met all three requirements of the GWE, so the payments were excludible from the recipients’ income. This ruling suggests that taxpayers who have already personally expended funds can still benefit from the GWE, because reimbursement should not affect the GWE’s applicability.

Services Not Allowed

The third prong of the GWE requires that payments cannot be made for services performed.⁴³ Payments for services constitute taxable income.⁴⁴ For example,⁴⁵ Massachusetts had a program under which its senior citizens received property tax abatements for performing voluntary community service. These payments were found to be includible in the seniors’ incomes because 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 have to 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 Service's position. For example, in *Bannon*⁴⁶ the taxpayer received money from the San Joaquin County Human Resources Agency for taking care of her mentally retarded adult daughter. These services could have been (and sometimes were) provided by third parties. The court held the 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, which were to provide in-home support services to her as a disabled citizen, were not includible in gross income.⁴⁷

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, this area has provided a slew of GWE authority over the years. Generally speaking, payments for unemployment compensation have met the GWE requirements.⁴⁸ Nevertheless, confusion arose from legislation enacted in many states under which recipients of unemployment benefits had to perform some level of service to receive their benefits.

As noted above, the requirement that a person provide services will disqualify a payment from meeting the GWE. On the other hand, training performed by a welfare recipient is allowed under the GWE. Thus, the application of the GWE to welfare benefits seems to be based on whether the required activity is in the nature of training, rather than in the nature of services. Consequently, vocational and occupational training received by recipients designed to upgrade basic skills (such as remedial education) should not cause the benefits provided to fail to come within the GWE.⁴⁹

The GWE has also been applied to payments to work-training participants when the payments were made by a state welfare agency based on need, and not for the value of the services performed.⁵⁰ In contrast, if the training is on-the-job experience, payments may be includible 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 includible in income.⁵¹ 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 includible in income.⁵²

Conclusion

The GWE is a relatively unknown income exclusion doctrine that continues to fly under the radar of 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, adoption and even crime victim restitution.

Will the Service 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 a 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 (such as 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 cannot be taxable" theory. However, there is 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.

Even in this era of strict tax practitioner scrutiny, there does not (yet) appear to be any authority which suggests that ignorance of the GWE is malpractice. Still, tax advisers would do well as a group to consider the GWE in appropriate cases.