

## Updating General Welfare Exception Authorities

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (<http://www.woodporter.com>), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. 2008) and *Qualified Settlement Funds and Section 468B* (2009), both available at <http://www.taxinstitute.com>. This discussion is not intended as legal advice, and cannot be relied on for any purpose without the services of a qualified professional.

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Four years ago, I wrote about a relatively unheralded nonstatutory exclusion from gross income known as the general welfare exception (GWE).<sup>1</sup> As a frequent tax adviser to litigants, I was surprised to find that the GWE from gross income was relatively unused in the context of settlement tax planning. It merited an examination of the exception, despite the rather narrow class of circumstances in which it can arguably apply. In this article, after briefly reviewing the GWE's major requirements, I survey the authorities applying (or rejecting) it since 2005.

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.<sup>2</sup> In general, income is defined as broadly as possible.<sup>3</sup> In contrast, exclusions are narrowly construed, and generally have been limited to those specified in the code.<sup>4</sup> With such an inauspicious foundation, it is almost surprising to find that the IRS has recognized the GWE as an uncodified exclusion from income.

The IRS has ruled that payments made under legislatively provided social benefit programs for promotion of the general welfare are excludable from gross income

under the GWE.<sup>5</sup> Not surprisingly, almost all IRS GWE authority contains that very language. There is little judicial authority on the GWE.<sup>6</sup>

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.<sup>7</sup> Throughout the ensuing 30 years, the IRS continued to issue opinions on the subject,<sup>8</sup> and by 1971 the IRS used the word "long-standing" to describe the GWE doctrine.<sup>9</sup>

Although it has been around for over 70 years, the GWE remains relatively unknown, escaping the notice of many tax practitioners. The doctrine and its policy 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 with a simple idea, it has been expanded to all sorts of government payments, ranging from disaster relief to payments for housing, education, adoption, and even crime victim restitution. 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.

In particular, creative tax planners may wish to consider whether the GWE may apply to payments from the government that the taxpayer receives only after suing. If there is a government welfare benefit, the applicability of the GWE should presumably not hinge on whether the benefit is voluntarily provided.

There are other questions worth asking: How can one police the line between necessities and luxuries? If the governmental agency and the taxpayer agree what constitutes "necessities" in one case, will that bind (or even influence) the IRS in other cases?

### A. GWE Requirements

The GWE requires that payments be made under legislatively provided social benefit programs for the

<sup>5</sup>See ITA 200021036 (Feb. 15, 2000), *Doc 2000-14946*, 2000 TNT 104-74; LTR 200451022 (Sept. 13, 2004), *Doc 2004-23902*, 2004 TNT 244-53.

<sup>6</sup>See *Bannon v. Commissioner*, 99 T.C. 59 (1992).

<sup>7</sup>See I.T. 3194, 1938-1 C.B. 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; and I.T. 3230, 1938-2 C.B. 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.

<sup>8</sup>See I.T. 3447, 1941-1 C.B. 191; Rev. Rul. 131, 1953-2 C.B. 112; Rev. Rul. 55-652, 1955-2 C.B. 21; Rev. Rul. 63-136, 1963-2 C.B. 19.

<sup>9</sup>GCM 34506.

<sup>1</sup>See Robert W. Wood and Richard C. Morris, "The General Welfare Exception to Gross Income," *Tax Notes*, Oct. 10, 2005, p. 203, *Doc 2005-20172*, or 2005 TNT 191-34.

<sup>2</sup>*United States v. Burke*, 504 U.S. 229 (1992).

<sup>3</sup>GCM 34424.

<sup>4</sup>*O'Gilvie v. United States*, 519 U.S. 79 (1996), *Doc 96-31894*, 96 TNT 240-1; *Commissioner v. Schleier*, 515 U.S. 323 (1995), *Doc 95-5972*, 95 TNT 116-8.

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promotion of the general welfare. In determining whether the GWE applies to payments, the IRS requires the payments to be:

- made from a governmental general welfare fund;
- for the promotion of the general welfare (that is, on the basis of need rather than to all residents); and
- not made as payment for services.<sup>10</sup>

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).<sup>11</sup> Grant payments that compensate for lost profits or business income (whether to individuals or to businesses) do not qualify for the GWE.<sup>12</sup>

**1. 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.<sup>13</sup> This requirement is relatively straightforward, and there does not appear to be any authority analyzing it.

In fact, in extant GWE authorities, it appears to be assumed that the payment originates in the general welfare fund (perhaps the IRS believes the source of the funds is easy to determine), so the first prong of the GWE is not discussed. That suggests that the determination of whether a payment is made from a governmental general welfare fund is mechanical. In any event, this requirement has not been subject to interpretive discussions to provide taxpayers guidance.

**2. 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 discussions and line drawing. Perhaps that is because precisely what promotes the general welfare can be a matter of opinion. The area continues to evolve, possibly suggesting a more expansive exception to gross income than might first seem apparent.

The inquiry whether a payment is for the promotion of the general welfare can be quixotic. The IRS has consistently ruled that the governmental payments must be made on the basis of need.<sup>14</sup>

<sup>10</sup>See ITA 200021036, *supra* note 5.

<sup>11</sup>Notice 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.

<sup>12</sup>Notice 2003-18, *supra* note 11; *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.

<sup>13</sup>See LTR 200451022, *supra* note 5, for application of the GWE to payments from the federal government. See ITA 200021036, *supra* note 5, for application of the GWE to payments from a state government. See *Bailey*, *supra* note 11, for application of the GWE to payment from a county government.

<sup>14</sup>See ITA 200022050 (Apr. 5, 2000), *Doc 2000-15570*, 2000 TNT 108-67; ITA 200017040 (Feb. 28, 2000), *Doc 2000-12060*, 2000 TNT 84-56; ITA 200016019 (Feb. 17, 2000), *Doc 2000-11659*, 2000 TNT 79-37; ITA 200013031 (Feb. 1, 2000), *Doc 2000-9671*, 2000 TNT 64-54.

**3. Services not allowed.** The third prong of the GWE requires that payments cannot be made for services performed.<sup>15</sup> Payments for services constitute taxable income.<sup>16</sup> That axiom is well illustrated in ILM 200227003.

There, a state of Massachusetts program provided senior citizens with property tax abatements for performing voluntary community service. The IRS found that those payments were includable in the seniors' incomes because they had to perform services to receive the payments. The legal memorandum also noted that the payments did not meet the second requirement of the GWE, that the payments be based on need. According to the memorandum, age is not a demonstrated need.

Since I last reviewed the GWE in 2005, there have been several new IRS administrative rulings and court decisions. The first group of authorities applies the GWE, and the second group rejects its application.

## B. Exclusions From Income Based on the GWE

**1. LTR 200632005.**<sup>17</sup> This letter ruling examined grants made by governing councils of Indian tribes to provide housing assistance for members under a needs-based priority system. Under the program, the tribe members could apply for grants to finance new home construction or rehabilitation of existing homes. To qualify, the tribe member's family gross income had to be less than the metropolitan statistical median gross income. The letter ruling finds that the grants made under the program were similar to benefits previously considered by the IRS in Rev. Rul. 75-271<sup>18</sup> (mortgage assistance programs with financial need determined under the Department of Housing and Urban Development guidelines within the GWE) and Rev. Rul. 77-77<sup>19</sup> (grants made under a governmental program designed to meet a legislatively identified need of Indians within the GWE). Thus, the grants from the councils were ruled to be within the scope of the GWE and excluded from the tribe members' gross income.

**2. ILM 200648027.**<sup>20</sup> This legal memorandum examined a state-sponsored health insurance program for individuals with income falling below a specified percentage of the federal poverty level. The program subsidized a portion of the health insurance premiums paid by employees of small businesses and self-employed individuals. The program also paid a portion of the premiums for individuals without health insurance. In each case, the subsidy was determined on a sliding scale based on the individual's income.

The legal memorandum concludes that the subsidy payments were not includable in gross income because of

<sup>15</sup>ILM 200227003 (Jan. 15, 2002), *Doc 2002-15743*, 2002 TNT 130-22.

<sup>16</sup>*United States v. Dieter*, No. 01-1435 (D. Minn. 2003), *Doc 2003-15194*, 2003 TNT 124-11.

<sup>17</sup>*Doc 2006-15385*, 2006 TNT 157-33.

<sup>18</sup>1975-2 C.B. 23.

<sup>19</sup>1977-1 C.B. 11.

<sup>20</sup>*Doc 2006-24227*, 2006 TNT 233-11.

the GWE. Among the factors relevant to the determination were that the subsidy payments were made from a governmental welfare fund, that the payments were based on the recipient's financial need and were not payable to all recipients regardless of financial status, and that the payments were not for services furnished by the recipient.

**3. LTR 200722005.**<sup>21</sup> This letter ruling examined a program instituted by a city to reimburse property owners for the costs of replacing existing driveway approaches (including sidewalks, curbs, and gutters within driveways) that were deteriorated, broken, or hazardous. Under easement laws, the city shared with property owners the responsibility of maintaining the driveway approaches. Generally, the city reimbursed property owners a maximum of 50 percent of the rehabilitation costs. However, some qualified seniors or disabled persons received 100 percent reimbursement. Property owners had to contact the city before beginning work and obtain approval to replace the driveway approaches. Only after the city inspected the work was the property owner reimbursed.

The letter ruling concludes that the reimbursements were not income to the property owners because the property owners lacked complete dominion over their driveway approaches, and the city substantially controlled the rehabilitation work. For the seniors who received 100 percent reimbursement, the additional reimbursement was also excluded from gross income under the GWE because the reimbursements were made from a governmental fund, were based on age and financial need or disability, and were not compensation for services.

**4. LTR 200808012.**<sup>22</sup> This letter ruling examined a state-sponsored program, paid from the state's general revenues, intended to address extreme (environmental disaster) hardship suffered by the state's homeowners. The program provided free home inspections, grants for home improvements, and interest payments on private loans. The program benefits were principally directed at moderate- and low-income households in the areas of the state affected by the hardship.

The letter ruling examined the holding of Rev. Rul. 98-19<sup>23</sup> (ruling that relocation payments made by a local government to individuals moving from flood-damaged areas to other residences are within the scope of the GWE). The letter ruling concludes that the payments made under the state-sponsored program were critically linked and commensurate with the specific problems presented, did not exceed necessary corrective action, and were principally directed at moderate- and low-income households located in areas suffering hardship. Thus, the inspections, grants, and interest payments were not gross income to the recipients because of the GWE.

**5. LTR 200810005.**<sup>24</sup> This letter ruling examined a state program to provide care for low-income elderly people in

family-type living arrangements as an alternative to nursing homes. To qualify for the program, the elderly person had to (1) be at least 60 years old, (2) have income not exceeding Medicaid limits, (3) be at risk for nursing home placement, and (4) live with an adult caregiver who provided supervision and care for the elderly individual. Under the program, a subsidy payment was made to offset the costs of support and maintenance of the elderly persons. The subsidy promoted the health and well-being of the elderly individuals by partially reimbursing the caregivers for some of the monthly living expenses of the elderly individuals and was not a payment for caring for the elderly individuals or for other services. Commercial caregivers were not eligible for the program.

The letter ruling concludes that the subsidy payments were not includable in the gross income of the elderly individuals on account of the GWE. The payments were made from a governmental fund under state statute, were based on economic need and on the health status of the elderly individuals, and were not for services. Although the payments were intended to reimburse the caregivers' expenses of promoting the health and well-being of the elderly individuals, the interposition of the caregivers as the recipients did not preclude application of the GWE.

**6. LTR 200845024.**<sup>25</sup> This letter ruling examined a program under which an Indian tribe provided payments to needy elderly members who had been displaced from their lands by a federal dam project. The program itself was funded by interest on a perpetual recovery fund established by the federal government as a replacement for loss value to the tribe on account of flooding caused by the dam. The interest on the perpetual recovery fund was to be paid to the tribe for educational, social welfare, economic development, and other public programs.

The particular program discussed in the letter ruling used a portion of the interest payments to make distributions to the original landowners or their first generation descendants over the age of 60 who had lost their land to flooding. The program was directed primarily at low- to moderate-income individuals and was not intended to compensate those individuals for their land losses.

The letter ruling concludes that this program was similar to the program discussed in Rev. Rul. 75-271<sup>26</sup> (mortgage assistance programs with financial need determined under HUD guidelines within the GWE) and Rev. Rul. 74-205<sup>27</sup> (replacement housing payments received under federal act by individuals displaced from their home within the GWE). The letter ruling provides that payments to the tribe members were excludable from income under the GWE because they were made by a governmental body, from a governmental welfare fund, under a legislative enactment, principally directed at

<sup>21</sup>Doc 2007-13205, 2007 TNT 107-24.

<sup>22</sup>Doc 2008-3735, 2008 TNT 37-17.

<sup>23</sup>1998-1 C.B. 840, Doc 98-10448, 98 TNT 59-9.

<sup>24</sup>Doc 2008-4993, 2008 TNT 47-29.

<sup>25</sup>Doc 2008-23714, 2008 TNT 218-65.

<sup>26</sup>1975-2 C.B. 23.

<sup>27</sup>1974-1 C.B. 20.

moderate-income level households and below, and reasonably linked with addressing the problems and needs arising from the dam dislocation.

**7. ILM 200908025.**<sup>28</sup> This legal memorandum examined a one-time payment made under a state program to taxpayers who purchased and installed energy efficient furnaces that met the “Energy Star” standards. The payments were for up to \$500 and were not dependent on the purchase price of the furnaces. The payments were made directly to or on behalf of low- and moderate-income households from the state’s general fund. The legal memorandum concludes that the payments were in the nature of general welfare and were not includable in gross income because they were analogous to the payments in Rev. Rul. 78-170<sup>29</sup> (payments made by a state to or on behalf of low- and moderate-income individuals to help reduce the cost of winter energy consumption were within the GWE).

**8. ILM 200910029.**<sup>30</sup> This legal memorandum examined a federal program that provided money to states to help individuals who had ongoing housing needs because of hurricanes Katrina and Rita. The states used the money to assist mostly low- and moderate-income individuals by helping them purchase a principal residence for the first time. The program allowed the state to sell principal residences to the eligible individuals at a discounted price.

The legal memorandum concludes that the individuals did not have to include in their income the discounted value of the principal residence they received under the program because provision of the residences was in the nature of general welfare. As authority, the IRS cites Rev. Rul. 74-205<sup>31</sup> (replacement housing payments received under a federal act by individuals who have been displaced from their homes were within the GWE) and Rev. Rul. 98-19<sup>32</sup> (relocation payments made by a local government to individuals moving from flood-damaged areas to other residences are within the scope of the GWE).

### C. Inapplicability of the GWE

**1. *Vogt v. Commissioner.***<sup>33</sup> *Vogt* examined payments made by the California Department of Social Services In-Home Supportive Services program (IHSS) to a father for the care of a mentally disabled minor son. Relying on *Bannon v. Commissioner*,<sup>34</sup> the court ruled that the IHSS payments to the father constituted gross income. The only factor that made the summary opinion distinguishable from *Bannon* was that the child of the recipient of the IHSS payments was a minor. Thus, the payments to the father were not within the GWE because they were payment for services.

**2. Rev. Rul. 2005-46.**<sup>35</sup> This revenue ruling examined a grant received by a business under a state program to reimburse businesses for losses incurred for damage or destruction of real and personal property on account of a disaster. Quoting *Bailey v. Commissioner*,<sup>36</sup> the ruling states that payments to businesses generally do not qualify under the GWE because the payments are not based on individual or family needs. The ruling concludes that the taxpayer could not exclude the grant payment from gross income under the GWE because that exclusion is limited to individuals who have received governmental payments to help with their individual needs (for example, housing, education, and basic sustenance expenses).

**3. *Wallace v. Commissioner.***<sup>37</sup> *Wallace* examined the GWE as it relates to the exclusion from gross income provided by section 140(a)(3) for veterans’ benefits (which at that time was section 139). In *Wallace*, the Tax Court ruled that income received by a taxpayer in connection with his participation in a work therapy program administered by the Department of Veterans Affairs (VA) was not includable in his gross income. The Tax Court held that the income was excluded from gross income by virtue of 38 U.S.C. section 5301(a) and section 140(a)(3).

The IRS argued that the monies paid to the taxpayer “for his participation in the program are unlike those payments made to taxpayers under legislatively-provided-social-welfare-benefit programs.” The Service argued that under the VA program, the taxpayer undertook compensated work therapy (sweeping floors and moving offices) so the nature of the payments to the taxpayer (compensatory) brought the income within the ambit of section 61.

The Tax Court disagreed:

While petitioner was compensated . . . we are inclined to conclude that distributions of that class are not simply payments for services rendered. There is a welfare (noncompensatory) aspect to them that inclines us to classify them as benefits along with other payments, such as education, training, and subsistence allowances.<sup>38</sup>

**4. ILM 200616031.**<sup>39</sup> This legal memorandum examined payments made by a state to its residents from surplus state funds. The payments decreased as the residents’ adjusted gross income increased. The payments were made to most of the state’s residents (rather than to a narrow class of residents who were in economic need), were not income tax refunds, and were not intended to be gifts.

The legal memorandum concludes that the payments were includable in income and not within the GWE because the payments were analogous to those made under the Alaska Longevity Bonus Act, discussed in Rev. Rul. 85-39<sup>40</sup> (payments made as an incentive to residents

<sup>28</sup>Doc 2009-3854, 2009 TNT 33-12.

<sup>29</sup>1978-1 C.B. 24.

<sup>30</sup>Doc 2009-5050, 2009 TNT 43-23.

<sup>31</sup>1974-1 C.B. 20.

<sup>32</sup>1998-1 C.B. 840.

<sup>33</sup>T.C. Summ. Op. 2005-107, Doc 2005-16129, 2005 TNT 144-11.

<sup>34</sup>99 T.C. 59 (1992).

<sup>35</sup>2005-2 C.B. 120, Doc 2005-14289, 2005 TNT 127-2.

<sup>36</sup>88 T.C. 1293 (1987).

<sup>37</sup>128 T.C. 132 (2007), Doc 2007-9677, 2007 TNT 74-9.

<sup>38</sup>*Id.* at 146.

<sup>39</sup>Doc 2006-7691, 2006 TNT 78-14.

<sup>40</sup>1990-2 C.B. 102.

to continue uninterrupted residence in the state are distinguishable from general welfare program payments when the bonus is payable to a state resident regardless of financial status, health, educational background, or employment status).

**5. LTR 200625006.**<sup>41</sup> This letter ruling examined a program instituted by a city to convert properties with multiple dwelling units, originally developed as either single-family residences or duplexes, back to their original use. Owners qualifying for benefits received amounts intended to compensate for the costs of conversion and lost rental income. The letter ruling points out that the program differed materially from a program described in Rev. Rul. 76-395<sup>42</sup> (payments made to low-income individuals to subsidize home improvements necessary to correct building code violations were within the GWE).

The letter ruling concludes that the grants to convert property were not within the GWE because there were no income restrictions for eligibility and the improvements were not intended to address building code violations necessary to make housing safe and decent. Also, because many of the properties involved rental property, the program provided benefits to an investment or business activity rather than addressing individual or family needs. (The ruling cites Rev. Rul. 2005-46).<sup>43</sup>

**6. LTR 200651003.**<sup>44</sup> This letter ruling examined a program instituted by a city to preserve architectural history and promote the quality of life in the community. Qualifying property owners received city grants for 50 percent of the cost of removing artificial siding from residences and restoring the original building materials. There were no income restrictions on eligibility for the grants.

The letter ruling notes that the program differed materially from a program described in Rev. Rul. 76-395.<sup>45</sup> The letter ruling concludes that the grants to

preserve architectural history were not within the GWE because there were no income restrictions for eligibility and the improvements were not intended to address building code violations necessary to make housing safe and decent. Also, the program did not require recipients to establish individual or family need, and owners of investment property were not precluded from receiving grants.

**7. LTR 200709008.**<sup>46</sup> This letter ruling examined a program instituted by a city to revive its downtown commercial buildings by providing building owners and long-term tenants incentives to undertake renovation projects. The program was available to owners and tenants regardless of their income levels. The letter ruling points out that the program differed materially from a program described in Rev. Rul. 76-395.<sup>47</sup> The letter ruling concludes that the renovations subsidized by the program were for commercial buildings and not for the promotion of general welfare, which is based on individual or family needs. Thus, the payments were not within the GWE.

#### D. Conclusion

Regardless of future doctrinal expansion, practitioners who do not explore the GWE may be overlooking a valuable possibility. It is conceivable that some taxpayers (and practitioners) may have reached results for some types of government benefits that are 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 the GWE could arguably be applied.

It is unreasonable to expect the GWE to become a major tool for tax planners or a major loss of revenue for the fisc. But for at least some situations, including some litigation settlements with governmental entities, the GWE may be worth examining.

<sup>41</sup>*Doc 2006-12270, 2006 TNT 122-56.*

<sup>42</sup>1976-2 C.B. 16.

<sup>43</sup>2005-2 C.B. 120, *Doc 2005-598, 2005 TNT 6-7.*

<sup>44</sup>*Doc 2006-25553, 2006 TNT 247-60.*

<sup>45</sup>1976-2 C.B. 16.

<sup>46</sup>*Doc 2007-5478, 2007 TNT 43-64.*

<sup>47</sup>1976-2 C.B. 16.

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