

## The Evergreen General Welfare Exception

By Robert W. Wood

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In this article, Wood considers the general welfare exception to gross income, pointing out that it can apply beyond the traditional context of governmental benefits. Wood reviews recent authority, concluding that this noncode provision is worth reviewing in the context of certain litigation settlements with the government.

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The general welfare exception (GWE) from gross income is not codified and not frequently discussed. Yet at times, it can prevent governmental grants and other governmental payments from being treated as income, avoiding the usual all income from every source precept. The GWE is not statutory. In short, it is fundamental stuff, as the IRS has long acknowledged.

The Service 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>1</sup> Almost all GWE authority contains that language. 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>2</sup>

<sup>1</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>2</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; I.T. 3230, 1938-2 C.B. 136, which concluded that payments on account of unemployment paid by a state agency out of funds

(Footnote continued in next column.)

Throughout the ensuing 30 years, the IRS issued rulings on the subject,<sup>3</sup> and by 1971 the IRS described the GWE as “longstanding.”<sup>4</sup> Despite more than 70 years of history, the GWE remains relatively unknown, escaping the notice of many tax practitioners. Although there are some key rulings, there is a paucity of judicial authority on the GWE.<sup>5</sup>

The doctrine and its policy seem simple: It doesn’t make sense for the government to tax government-provided assistance payments. The GWE has been applied to all manner of government payments, from disaster payments to housing, education, adoption, and even restitution to crime victims.

### GWE Requirements

For the GWE to apply, 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 the general population); and
3. not made as payment for services.<sup>6</sup>

The GWE has generally been limited to those who receive governmental payments to help them with their individual needs (for example, housing, education, and basic sustenance).<sup>7</sup> Grant payments that compensate for lost profits or business income (whether to individuals or businesses) do not qualify for the GWE.<sup>8</sup>

### Promotion of General Welfare Means Need

The requirement that the payment must be for the promotion of the general welfare accounts for most of the GWE authorities. Precisely what promotes the general welfare might be a matter of opinion. As tax lawyers, we are used to words being used in arcane and sometimes

received from the Federal Unemployment Trust Fund are not subject to federal income tax in the hands of the recipient.

<sup>3</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>4</sup>GCM 34506 (May 26, 1971).

<sup>5</sup>See *Bannon v. Commissioner*, 99 T.C. 59, 62 (1992): “Though no statutory exclusion for a welfare benefit appears in the Internal Revenue Code, and there is a dearth of case law on the subject, [the IRS] has consistently taken the position, in a number of Revenue Rulings, that Government disbursements promoting the general welfare are not taxable.”

<sup>6</sup>See ITA 200021036, *supra* note 1.

<sup>7</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>8</sup>Notice 2003-18, *supra* note 7; *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.

even bizarre fashion. Even so, the second prong of the GWE is an odd requirement.

To the IRS, however, it all boils down to need. The IRS has consistently ruled that the governmental payments must be made on the basis of need.<sup>9</sup> The payment must be for the “promotion of the general welfare,” which has been interpreted to focus on individual or family needs.

Indeed, in *Bailey v. Commissioner*,<sup>10</sup> the Tax Court noted that the GWE has been applied when a grant is received under a program requiring an individual recipient to establish his need. Conversely, the GWE should not apply to grants received under social welfare programs that do not require recipients to establish their individual need.

In a way, of course, this makes sense. The result is that when a state makes a payment to all adult residents regardless of need, the GWE cannot apply.<sup>11</sup> The general welfare focus has also ruled out most payments to businesses.<sup>12</sup>

Not surprisingly, most of the authorities arising under the GWE involve government payments for specific needs. And the Service has been relatively liberal in considering its applicability. For example:

- In LTR 200632005 (Apr. 13, 2006), *Doc 2006-15385, 2006 TNT 157-33*, the Service applied the GWE to grants from Indian tribes to provide housing assistance to members based on need.
- In ILM 200648027 (July 25, 2006), *Doc 2006-24227, 2006 TNT 233-11*, the Service ruled grants under a state-sponsored health insurance program for low-income individuals were excluded from income under the GWE.
- In LTR 200722005 (Feb. 27, 2007), *Doc 2007-13205, 2007 TNT 107-24*, payments to low-income seniors under a city’s program to reimburse property owners for replacing driveway approaches were covered by the GWE.
- LTR 200808012 (Nov. 20, 2007), *Doc 2008-3735, 2008 TNT 37-17*, applied the GWE to needs-based payments to citizens suffering hardship from an environmental disaster.
- LTR 200810005 (Dec. 5, 2007), *Doc 2008-4993, 2008 TNT 47-29*, excluded state housing subsidy payments to low-income elderly people because of the GWE.
- In LTR 200845024 (July 8, 2008), *Doc 2008-23714, 2008 TNT 218-65*, the GWE was ruled to extend to Indian tribe payments to needy elderly tribe members displaced by a dam project.
- ILM 200908025 (Nov. 5, 2008), *Doc 2009-3854, 2009 TNT 33-12*, involved state payments to low-income

people who installed energy efficient furnaces that were excludable under the GWE.

- In ILM 200910029 (Feb. 2, 2009), *Doc 2009-5050, 2009 TNT 43-23*, the Service excluded under the GWE federal government housing payments to low- and moderate-income persons affected by hurricanes Rita or Katrina.

### Recent Ruling

The most recent iteration of the GWE appears in LTR 201004005 (Oct. 21, 2009), *Doc 2010-2221, 2010 TNT 20-24*. An entity requested a ruling that its grants need not be the subject of a Form 1099 because the grants are covered by the GWE. The facts make it clear that this was a government program with a spin.

The governor of a state formed a group to address a particular condition and industry. The group recommended a program and the state enacted it. Administered by entity, a public corporation of the state, it offered grants to buyers who purchased a particular kind of property.

There were conditions on the grant money, including the requirement that a buyer had to occupy the property in a specific manner within a set number of days following purchase. The buyer would also have to pay cash or qualify for a loan from a lender who participated in the program. Finally, there were income limitations.

The program was supposed to require that the buyer’s adjusted gross income not exceed a particular level. However, the governor’s advisory group and the state legislature were concerned that by restricting participation based on low-income levels they would not achieve the program’s objective. Therefore, people with gross incomes above the stated level also received grants.

The entity sought a ruling that the grants were not gross income to buyers under one of two theories: Either they represented a purchase price reduction for the subject property, or they were excludable under the GWE. Clearly, argued the entity, the grants promoted the general welfare of state residents by stimulating the particular industry targeted by the program, which was a key segment of the state’s economy. Besides, the grants benefited participants who were principally persons of low and moderate income.

The entity did show that the statistics for the program proved that the median income of a buyer receiving a grant was a particular percent of the statewide median income figures. Yet this was not the same as the lower income echelon that the program was specifically designed to address. As you might expect, despite the organization’s various arguments, the IRS found that the program did not qualify for the GWE.

In the IRS’s view, payments were not targeted to particularized individual or family needs. In fact, the Service found that the program itself was created to give economic stimulus to the state economy and to a particular industry. That was its purpose. The program was intended to benefit *all* state residents by stimulating that industry.

In contrast, for the GWE to apply, grants would have to be made to individuals based on their *individual* need. The governor’s group and the state legislature did not restrict grants under this program to individuals of a

<sup>9</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*.

<sup>10</sup>88 T.C. 1293 (1987), *acq. on another issue* 1989-2 C.B. 1.

<sup>11</sup>See Rev. Rul. 85-39.

<sup>12</sup>See Rev. Rul. 2005-46, 2005-2 C.B. 120, *Doc 2005-14289, 2005 TNT 127-2*.

specified lower income. The IRS speculated that the state chose not to restrict grants because to do so would not have produced the desired result. The state was trying to achieve general economic remediation.

The Service pointed out that the entity that applied for the ruling did not ever state that the purpose of the program was to help needy persons purchase the properties in question. Moreover, as the IRS noted, the program required participants to either pay cash for the property or to be sufficiently solvent to obtain and be able to service a loan.<sup>13</sup> That meant the grants were obviously not made to individuals based on financial need. In fact, the Service found that it seemed the opposite: Individuals would receive a grant only if they had the ability to *pay*.

Although all of the percentage figures are redacted from the ruling, the Service also pointed out that a particular portion of the taxpayers did meet the income limitations enunciated in the program. However, those limitations standing alone were not enough to establish need, the IRS said. The Service characterized this program as similar to those under which payments are made to state residents regardless of financial status, health, educational background, or employment status.<sup>14</sup> Thus, the IRS simply found that the grants under the program could not qualify under the GWE.

The ruling concludes that the grant payments were also not in the nature of purchase price reductions. Although irrelevant to the GWE, that is an interesting finding. The entity was not a party to any of the sales transactions between buyers and sellers. Therefore, the grant could not operate to reduce purchase price.<sup>15</sup> Finally, because neither the GWE nor purchase price reduction arguments prevailed, the Service ruled that the payments were subject to the Form 1099 rules of section 6041.

### Needy Details

Is it necessary under the GWE for a payment to be based on individual financial needs, or may it simply be based on individual needs? Specifically, suppose taxpayers sue local government, claiming that their child was not properly educated as required by law. The school district and local government settle, awarding a payment from the county's general fund that is devised to adequately educate the child. Is it income?

It is, of course, not a governmental program. It is a payment to resolve a lawsuit. Yet it is plainly intended to perform a governmental function: to educate. And it is plainly targeted to an individual need. Thus, it seems (at least to me) to be:

- made from a governmental fund (more about this below);

<sup>13</sup>The redactions in the ruling are extensive, so it is not entirely clear that items "D and E" are loans and loan payments. However, I think this is what they represent.

<sup>14</sup>See Rev. Rul. 76-131, 1976-1 C.B. 16.

<sup>15</sup>See Rev. Rul. 2008-26, 2008-21 IRB 985, *Doc 2008-10310*, 2008 TNT 92-40; Rev. Rul. 2006-27, 2006-1 C.B. 915, *Doc 2006-8700*, 2006 TNT 87-11; and Rev. Rul. 76-96, 1976-1 C.B. 23.

- made for the promotion of the general welfare, meaning it is generally based on individual or family needs — what the lawsuit was all about; and
- not compensation for services.

### Payment Origin

The first listed prong of the GWE requires the payment to be made from a governmental general welfare fund. It does not seem to matter whether these payments originate from the federal government, a state government, or a county government.<sup>16</sup> The fact that a payment originates in the general fund appears to be assumed, because it is not generally discussed.

*Black's Law Dictionary* defines a "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 goes on to note that a general fund is distinguished from assets of a special character, such as trust, escrow, and special-purpose funds.<sup>17</sup>

Governmental entities seem to adopt the same definition, although it does seem surprising that there are few discussions on this point. For example, the federal government generally divides all budget accounts into two groups: the federal funds group and the trust fund group.<sup>18</sup> Among the federal funds group, the general fund "is the largest fund in the government and used for the general purposes of government rather than being restricted by law to a specific program."<sup>19</sup> According to the Office of Management and Budget, the general fund receives all collections not dedicated for some other fund; it includes virtually all income taxes and many excise taxes. The general fund is used for all programs not supported by trust, special, or revolving funds.<sup>20</sup>

In contrast to the general fund, the federal funds group also includes "special funds" which are used when the law requires that federal fund collections be dedicated to a particular program, and "revolving funds" that receive proceeds from the sale of products or services, where those proceeds finance ongoing activities that continue to provide products or services.<sup>21</sup>

Similarly, in San Francisco, where I live, money — when it is available — is disbursed from a variety of funds, which include: the "general fund," which accounts for all financial resources except those required to be accounted for in another fund; the "special revenue funds," which account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes; the "debt service funds," which

<sup>16</sup>See LTR 200451022, *supra* note 1, for the application of the GWE to payment from the federal government. See ITA 200021036, for the application of the GWE to payment from a state government. See *Bailey*, 88 T.C. 1293, for the application of the GWE to payment from a county government.

<sup>17</sup>See *Black's Law Dictionary*, 7th ed., p. 682 (1999).

<sup>18</sup>See "Analytical Perspectives, Budget of the U.S. Government Fiscal Year 2010," p. 341, available at <http://www.whitehouse.gov/omb/budget/fy2010/assets/spec.pdf>.

<sup>19</sup>*Id.*

<sup>20</sup>*Id.*

<sup>21</sup>*Id.*

provide for the payment of long-term obligation principal, interest, and related costs; and the “capital projects funds,” which provide resources for the acquisition or construction of major capital facilities.<sup>22</sup>

I don’t know how important it is to the application of the GWE that taxpayers observe these nuances, but it might be important.

### Services Not Allowed

Finally, payments cannot be made in exchange for services performed.<sup>23</sup> Clearly, those payments constitute taxable income.<sup>24</sup>

### Conclusion

The GWE will never have broad application because of its exacting requirements. Yet it is being applied more frequently in these hard economic times and probably merits a closer look in at least some litigation settlements with the government. Sometimes, the GWE shoe may just fit.

<sup>22</sup>See <http://www.sfgov.org/site/uploadedfiles/controller/cafr/98/finpg14.pdf>.

<sup>23</sup>ILM 200227003 (Jan. 15, 2002), Doc 2002-15743, 2002 TNT 130-22.

<sup>24</sup>*United States v. Dieter*, 2003 U.S. Dist. Lexis 6391; 91 AFTR 2d 1891, Doc 2003-15194, 2003 TNT 124-11.

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