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The IRS's General Welfare Exclusion

The Internal Revenue Service (IRS) has concluded that certain payments under legislatively provided social benefit programs that promote the general welfare are excludable from a recipient's gross income and thus are not subject to tax. The general welfare exclusion is not based on any specific statutory or regulatory authority. However, courts and the IRS have long recognized this non-statutory exception to the general rule that all income is subject to tax unless specifically exempted by Congress. The general welfare exclusion provides the IRS with flexibility to address unanticipated issues arising from legislatively provided social benefit program payments. This In Focus discusses the origins and rationale behind the IRS's general welfare exclusion; provides an overview of instances in which the general welfare exclusion has been applied; and reviews examples of Congress's intervention to partially codify the general welfare doctrine or overturn a past IRS exclusion.

Origins of the General Welfare Exclusion

Since the 1930s, the IRS has contended that the general welfare exclusion is an administrative exception to the statutory definition of gross income. Internal Revenue Code (IRC) Section 61(a) defines *gross income* for federal income tax purposes as "all income from whatever source derived" except as otherwise provided in IRC Subtitle A, which contains the rules specific to federal income taxes. The Supreme Court has often stated that the broad phraseology in IRC Section 61, and its predecessors, is evidence of Congress's intent to use the full measure of its taxing power to reach undeniable accessions of wealth. Treasury Regulation Section 1.61-1(a) clarifies that gross income includes income realized in any form, such as money, property, or services. In 1995, the Supreme Court explained in *Commissioner v. Schleier*, 515 U.S. 323 (1995), that the corollary to the sweeping scope of IRC Section 61(a) is that exclusions from gross income are narrowly construed.

The IRS and commentators trace the origin of the general welfare exclusion to a series of IRS office decisions issued in 1938, following the 1935 passage of the Social Security Act (P.L. 74-271). One of the act's purposes was "to provide for the general welfare by establishing a system of Federal old-age benefits, and by enabling the several States to make more adequate provision for aged persons, blind persons, dependent and [disabled] children, maternal and child welfare, public health, and the administration of their unemployment compensation laws." Without providing an explanation, the IRS announced in Office Decision 3194 that lump-sum payments made under Section 204(a), Title II, of the Social Security Act to aged individuals were "not subject to income tax in the hand of the recipients." Again, without providing an explanation, the IRS announced in Office Decision 3229 that lump-sum payments to a deceased employee's estate under Sections 203 and 204(b), Title II, of the Social Security Act also were not subject to income tax. Then, the IRS announced in Office Decision 3230, also without an explanation, that unemployment compensation paid by a state agency from the Federal Unemployment Trust Fund established by Section 904, Title IX, of the Social Security Act was not subject to income tax in the hands of the recipient. Beginning in 1984, Congress partially eliminated the exclusion of Social Security benefits from gross income under IRC Section 86. Then, in 1986, Congress made unemployment compensation includible in gross income under IRC Section 85.

In 1975, the IRS issued General Counsel Memorandum 36470, in which it took a hard look at its prior applications of the general welfare exclusion. In its review, the IRS explained that it believed it was "well within its authority" to apply the general welfare exclusion where Congress intended for a payment to be excluded, including where Congress did not explicitly state its intent in legislation. The IRS also announced that it could exclude analogous state payments from federal gross income if the payments were not in the nature of compensation.

Later, in an IRS Field Service Advisory dated March 24, 1998, the IRS clarified that its rationale for the general welfare exclusion was that Congress intended for certain federal payments to be exempt from gross income even though Congress did not expressly exclude the payments in legislation or state that intent in legislative history. The IRS also acknowledged that the extension of the general welfare doctrine to state payments that were analogous to federal payments was "initially problematic" because state legislatures could not create federal income tax exclusions. Still, the IRS claimed the general welfare exclusion "evolved" to exclude analogous state payments by "administrative fiat."

Application of the General Welfare Exclusion

Over the years, the IRS has excluded various payments from gross income under the general welfare exclusion via administrative rulings, such as state payments to blind persons (Revenue Ruling 57-102, 1957-1 C.B. 26); job-training program payments to unemployed and underemployed individuals to enhance employability (Revenue Ruling 68-38, 1968-1 C.B. 446); state payments to crime victims (Revenue Ruling 74-74, 1974-1 C.B. 18); state payments to adoptive parents for support and maintenance of their adoptive child (Revenue Ruling 74-153, 1974-1 C.B. 20); replacement housing payments (Revenue Ruling 74-205, 1974-1 C.B. 21); payments to workers who became unemployed mainly because of adverse impacts on their employers caused by increased imports due to changes in trade policy (Revenue Ruling 76-229, 1976-1 C.B. 19); disaster payments to meet necessary expenses or serious needs that included medical, dental, housing, personal property, transportation, and funeral expenses (Revenue Ruling 76-144, 1976-1 C.B. 17); and state credits to offset the cost of winter energy consumption (Revenue Ruling 78-170, 1978-1 C.B. 24).

In Revenue Ruling 2005-46, 2005-2 C.B. 120, the IRS clarified that, for a payment to qualify under the general welfare exclusion, the payment must (1) "be made from a governmental fund"; (2) "be for the promotion of the general welfare (*i.e.*, generally based on individual or family need)"; and (3) not represent compensation for the performance of services. Some commentators assert that the IRS's development of the general welfare doctrine has been ad hoc, inconsistent, and unpredictable, most notably when determining whether a payment is based on need.

Over time, the IRS has ruled that the need criterion is met not only when a payment determination is made based on a recipient's financial situation but also when specific circumstances convey that a recipient has a situational need. For example, in Revenue Ruling 98-19, 1998-1 C.B. 840, the IRS ruled relocation payments to defray the expenses of moving from a flood-damaged residence to another residence qualified for the general welfare exclusion. The statute authorizing the payments, 42 U.S.C. § 5305, did not require the grantees of the payments to evaluate recipients' financial need; rather, the recipient had "to be appropriate."

To provide recipients of disaster-related payments with certainty and clarity, in 2001, Congress partially codified the general welfare exclusion for specific disaster-related payments. The Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134) added IRC Section 139, which provides that gross income includes no amount received by an individual as a "qualified disaster relief payment." A qualified disaster relief payment includes an amount paid to or for the benefit of an individual to pay or reimburse (1) reasonable and necessary personal, family, living, or funeral expenses incurred because of a qualified disaster or (2) reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence, and its contents, if the need to repair, rehabilitate, or replace is attributable to a qualified disaster. IRC Section 139 does not restrict the source of the qualified disaster relief payments and does not require the qualified disaster relief payments to be based on individual or family need. A qualified disaster relief payment also includes an amount paid to or on behalf of an individual by a federal, state, or local government in connection with a qualified disaster to promote the general welfare. Qualified disaster relief payments do not include payments for expenses that are compensated for by insurance. *Qualified disasters* include disasters resulting from a terroristic or military action as defined in IRC Section 692(c)(2), federally declared disasters as defined in IRC Section 165(i)(5)(A), and any event the Secretary of the Treasury determines to be of a catastrophic nature.

In Revenue Ruling 2005-46, 2005-2 C.B. 120, the IRS explained that payments to businesses generally do not qualify for the general welfare exclusion because the payments are not based on individual or family need. Some commentators, meanwhile, point to an earlier ruling, Revenue Ruling 77-77, 1977-1 C.B. 11, in which the IRS concluded that Indian Business Grants paid to Indians and Indian Tribes under Title IV of the Indian Financing Act of 1974 (P.L. 93-262) were excludible from gross income under the general welfare doctrine. The grants paid through the Indian Business Development Program were to stimulate and increase entrepreneurship and employment by providing equity capital to establish and expand profit-making Indian-owned economic enterprises on or near reservations. Commentators observed that these grants did not appear to be awarded based on individual need and that individuals and tribes were eligible for the general welfare exclusion under the rule.

In response to the uncertainty surrounding tribal general welfare benefits, the Tribal General Welfare Exclusion Act of 2014 (P.L. 113-168) added Section 139E to the IRC, which partially codifies the general welfare exclusion for certain tribal program benefits. An Indian general welfare benefit includes any payment made or service provided to or on behalf of a member of an Indian tribe (or any spouse or dependent of such a member) under an Indian tribal program. The program must (1) be administered under specified guidelines; (2) not discriminate in favor of members of the tribe's governing body; and (3) provide benefits that are (a) available to any tribal member (including spouses and dependents) who meets the guidelines, (b) for the promotion of general welfare, (c) not lavish or extravagant, and (d) not compensation for services. IRC Section 139E's legislative history suggests that Congress intended that "in no event will the IRS require an individualized determination of financial need where a Tribal program meets all other requirements of new section 139E."

Considerations for Congress

The partial codification of the general welfare exclusion has provided certainty to some recipients of legislatively provided social benefit programs that otherwise would have been subject to the IRS's administrative rule. These statutes do not supplant the IRS's general welfare exclusion. The IRS still must fill in gaps and determine when a legislatively provided social benefit program payment is excludible from gross income absent explicit legislative instruction. While a few courts, such as the frequently cited Tax Court decision in *Bailey v. Commissioner*, 88 T.C. 1293 (1987), have acknowledged the general welfare exclusion's existence and reviewed its history, courts have largely relied on IRS revenue rulings when determining whether a payment qualifies for the exclusion and generally do not directly address the IRS's interpretation of the general welfare doctrine and its validity. Some commentators contend that Congress should enact legislation defining the general welfare exclusion to provide greater certainty to recipients of legislatively provided social benefit programs and limit the general welfare exclusion to ensure an application that is more consistent.

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