The General Welfare Exclusion

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The Internal Revenue Service has concluded that certain need-based state and federal payments may be excluded from taxation under a concept known as the general welfare exclusion.

Gross income subject to taxation is broadly defined

The starting point for determining the federal individual income tax is determining gross income.[1] For purposes of this determination, income is broadly defined by the Internal Revenue Code (IRC).[2] A good rule of thumb is that unless the IRC specifically excludes an item of income, the item of income is taxable.[3]

The general welfare exclusion is a nonstatutory exclusion from gross income

One important exception to the above-stated rule of thumb is the general welfare exclusion. Under this exclusion, some items of income are excluded from gross income despite the absence of a specific statutory exclusion under the IRC. The exclusion is the product of an administrative doctrine developed by the Internal Revenue Service (IRS) beginning with an office decision in 1938, holding that certain lump-sum payments made under the recently enacted Social Security Act were not subject to tax.[4]

Over time, the exclusion grew to encompass a variety of federal and state payments to individuals.[5] In 2002, the IRS formalized the doctrine in Notice 2002-76, and provided a three-part test to determine whether a state or federal payment may be excluded. Under this test, the payment must:

1) be made from a governmental fund;
2) be for the promotion of the general welfare (based on need); and
3) not represent compensation for services.

Most controversies have arisen under prong two of this test.[6] There are two general ways in which the need-based requirement has been met. First, need may be shown due to a specific situational need of

[1] 26 U.S.C. § 61.

[2] The United States Supreme Court has held that "gross income" includes "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." C.I.R. v. Glenshaw Glass Co., 75 S.Ct. 473, 477 (1955).

[3] The IRC's exclusions are under 26 U.S.C. §§ 101 through 140. In addition, the code also provides for items of income that are specifically included under 26 U.S.C. §§ 71 through 91.

[4] See Milan N. Ball, *The IRS's General Welfare Exclusion,* Congressional Research Service (Feb. 9, 2023), citing I.T 3194 from 1938.

[5] See e.g., Revenue Ruling 55-652 (providing that federal or state unemployment payments made to individuals under the Social Security Act are not subject to tax); Revenue Ruling 57-102 (providing that a Pennsylvania benefit paid to a blind person was excluded from gross income); Revenue Ruling 78-170 (providing that an Ohio credit to elderly and disabled persons for their winter energy bills were excluded from gross income).

[6] See e.g. *Bailey v. C.I.R.,* 88 T.C. 1293 (1987) (providing that a grant intended to promote the general welfare of the community did not qualify for the general welfare exclusion because it was not based on need); *Maines v. C.I.R.*, 144 T.C. 123 (2015) (brownfield redevelopment credit received from the state was not excluded because credit received was not based on a showing of need); *Ginsburg v. U. S.,* 136 Fed. Cl. 1 (2018) (providing that welfare program grants that do not require recipients to demonstrate need do not qualify for exclusion).

By **Christopher Kleman,** Christopher.Kleman@house.mn.gov

an individual, for instance a state payment to individuals to cover unreimbursed disaster-related expenses.[7] Second, need may also be shown by reference to income levels. For instance, the IRS has upheld payments made by the state of North Carolina for hurricane relief to individuals who qualified as low-income, which the state defined as income that does not exceed 80 percent of the adjusted median income for various geographical areas.[8] While there is no definitive guidance from the IRS on what income levels may allow a payment to qualify as need-based, the IRS did not exclude payments made by the state of Minnesota in 2023 under this doctrine because the income thresholds used by the state ($75,000 for single filers and $150,000 for married joint filer) were too high.[9]

Minnesota conforms to IRS determinations on taxability

The starting point for the calculation of the Minnesota individual income tax is federal adjusted gross income (FAGI). In general, the state therefore adopts not just the federal statutory system for determining FAGI, but also the IRS guidance pertaining to these statutes, including the IRS determinations under the general welfare exclusion. This means that, unless the legislature acts, federal rules regarding whether a state payment is included or excluded from FAGI will apply under the state individual income tax as well.

For payments that are or might be included in gross income federally under the IRC or the general welfare exclusion, the legislature must enact a state subtraction for the income separately, if it does not want the income to be taxed at the state level.

IRS determinations are not predictable

Legislators who enact a state payment not specifically excluded from gross income under the IRC should be cautioned that it is difficult to predict whether the IRS will exclude the payment under the general welfare exclusion. This is because the exclusion is an administrative doctrine for which the case law is scant and there are no formal regulations. At times, though, the IRS has issued guidance to states on whether certain payments will be taxable, such as for certain state payments made during the COVID pandemic.[10] There is a greater likelihood that the general welfare exclusion will apply, however, if legislation is developed intentionally to satisfy the three-part test and specifically to conform to the need-based requirement under this doctrine.

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[7] See e.g., Revenue Ruling 2003-12 (providing that state payments to individuals for certain unreimbursed flood losses were excluded from gross income). This ruling also concludes that 26 U.S.C. section 139(b)(4) (providing an exclusion for certain qualified disaster relief payments made by governments "in order to promote the general welfare") partially codifies the general welfare exclusion as applied to some of these payments.

[8] IRS Chief Counsel Advice memorandum, number 200022050 (6/2/2000).

[9] See letter from IRS Commissioner Daniel I. Werfel to U.S. Rep. Pete Stauber, January 19, 2024, available at: https://stauber.house.gov/sites/evo-subsites/stauber.house.gov/files/evo-media-document/commissioner-werfel-letter-to-stauber.pdf. Commissioner Werfel also states in this letter that "[t]he general welfare exclusion is generally limited to payments made to low-income recipients." It may be that the greater proportion of the payments excluded are made on the basis of income, which may be due in part today to the partial codification of the exclusion for disaster relief referenced in note 6, which does not define need solely on the basis of income.

[10] See "IRS issues guidance on state tax payments," IR-2023-158, Aug. 30, 2023, available at https://www.irs.gov/newsroom/irs-issues-guidance-on-state-tax-payments.