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GOVERNMENT TRANSFER PAYMENTS AND ASSISTANCE: A CHALLENGE FOR THE DESIGN OF BROAD-BASED TAXES

Charlotte Crane*

MANY conventional analyses of the income tax focus on the taxpayer and his ability to pay. The concern in such analyses is whether the income tax, as currently defined, accurately includes the values available to the taxpayer for consumption. This focus on the ultimate consumption of the individual taxpayer, in assessing the adequacy of the tax-base definition, is largely the natural result of the focus on the progressive possibilities of the income tax.¹ Any effort to make the income tax progressive merely through rates to be applied to income seems superfluous if there are systematic omissions from the tax base undercutting such efforts. Only if all consumption values available to a taxpayer are included in the tax base can the overall progressivity of the tax be assured.

As long as this focus on progressivity is a primary concern in efforts to explicate the income tax base, there seems to be relatively little reason for concern about the omission of various types of values that are only incompletely distributed and consumed through markets. Such values,

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1. Progressivity has itself been justified in terms of utilitarian approaches to the marginal utility of income, in terms of presumptions about the relative levels of discretionary spending, and on more direct redistributive grounds. See generally Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 YALE L.J. 1391, 1399-1411 (2002) (reviewing PAUL W. McCracken, *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (2000)). Although the justification for progressivity may affect one's views on the significance of various deviations from a completely comprehensive tax, as long as one accepts progressivity in rates through any substantial range of income classes, the need to be comprehensive is obvious. Progressivity is coherent only if the tax base is either broadly defined, or if it allows only those specific exclusions consonant with the chosen justification for progressivity.

The need for a comprehensively defined tax base is also derived from efforts to avoid distortion in the economy by favoring, through incomplete inclusion, certain economic activities and the income streams they generate.

Numerous works establish the notion of a comprehensive tax base. See generally BORIS I. BITTKER ET AL., *A Comprehensive Tax Base? A Debate* (1968); STUDIES OF GOVERNMENT FINANCE, THE BROOKINGS INSTITUTE, *Comprehensive Income Taxation* (Joseph A. Pechman ed., 1977); Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Charles Galvin, *History of the Substantive Tax Reform Project*, in *STUDIES IN SUBSTANTIVE TAX REFORM* 3 (A. Willis ed., 1969); R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967); Joseph A. Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967).

including imputed income from personal services, the value of government services received, and even transfer payments of cash, seem relatively unimportant in determining either the relative overall well-being of taxpayers or the relative ability of taxpayers to pay. Such items are either likely to be received by virtually all taxpayers or by only taxpayers whose ability to pay, even if these values were included in their tax base, would still be minimal. The failure to include such values when they are only available for consumption by taxpayers who are less well off (even if the standards by which they are deemed less well off are not the same as those used in the income tax) seems a trivial matter.² It is easy to see, therefore, why such values have frequently been excluded from the income tax base, as they frequently have been under the IRS' "general welfare doctrine."³ If only those taxpayers otherwise taxed at the lowest rates receive excluded payments, the exclusions at worst only enhance the social program through which they are received. If the program generating the excluded receipts is itself relatively broadly enjoyed among lower income taxpayers, the exclusions create an ad hoc additional lower bracket.

Other approaches to defining income may also suggest that excluding various types of income, even those not enjoyed in relatively equal proportions across income classes, should be of little concern. Exclusions and other preferences can lead to distortions in taxpayer behavior when taxpayers rearrange their activities to enjoy more of the preferred receipts. But if taxpayers are relatively constrained in their ability to rearrange

2. The relationship between progressivity and fairness is not always invoked in the ways one would expect. For instance, the Joint Committee explanation of the removal of an exemption for unemployment payments justified the change as one that provided "more equal tax treatment of individuals with the same economic income." STAFF OF J. COMM. ON TAXATION, 99TH CONG., EXPLANATION OF THE TAX REFORM ACT OF 1986 29 (Comm. Print 1987).

3. Concern was expressed about the scope of exclusions under the general welfare doctrine in the earliest calls for a comprehensive tax base. See, e.g., Joseph A. Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1, 12-14 (1957); Joseph A. Pechman, *What Would a Comprehensive Individual Income Tax Yield?*, in 1 TAX REVISION COMPENDIUM 251 (1959). This concern was expressed at the time when, according to the author's estimates, about twenty billion dollars in cash payments, including social security, unemployment, and veterans benefits, were excluded from a total tax base of about three hundred billion dollars. Pechman's primary concern in these early works appears to have been simply the appearance of unfairness in the exclusion of amounts that represented the equivalent of payments that were in fact taxed. None of these payments are now dealt with under the amorphous general welfare doctrine: social security payments are partially taxed under § 86, added to the Code by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 65, 80-84; unemployment benefits are taxed under § 85, added to the Code by the Revenue Act of 1978, Pub. L. No. 95-600, Title I, § 112(d), 92 Stat. 2763, 2777-78, and the exclusion of military and veterans benefits are largely governed by § 134, added to the Code by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 116(a), 100 Stat. 2085, 2512-13. Pechman's willingness to tax even means-tested transfer payments made him a relatively easy target for those who found the quest for a comprehensive tax base futile. See, e.g., Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, *supra* note 1, at 937.

The Carter Commission Report, thought by many to be the high-water mark of pragmatic thinking about a comprehensive tax base, would have included all government transfer payments. 1 REP. OF THE ROYAL COMM'N ON TAX'N 17 (1966).

their affairs to enjoy such receipts—as they may be with respect to most kinds of transfer payments—this concern about distorting behavior and the resulting misallocation seems of little importance. Only if we are concerned that the exclusions distort the means by which transfer payments are delivered, as might happen if the exclusion is dependent upon the means of payment or the payor's identity, should we be concerned about distortions in the economy.⁴ Nor should exclusions under the general welfare doctrine be problematic from the point of view of those who would want to identify deviations from a fully comprehensive tax base as “tax expenditures” because of concerns about the legitimacy of the political processes by which such benefits can be bestowed. Receipts excluded under the general welfare doctrine are, almost by definition, already under the jurisdiction of policy makers and administrators outside of the tax system. While actual expenditures in their programs may be understated to the extent that recipients receive not only a transfer payment, but also the tax value avoided as a result of the exclusion, failing to identify those additional expenditures in most instances would seem to involve very different concerns.⁵

The exclusion of such amounts does not, however, sit easily with several other aspects of the income tax.⁶ Many of the resulting problems

4. The resulting distortion may be of concern. The question is whether it is inappropriate to privilege government delivery over private delivery of social services, if only the latter are to be granted special treatment. But identifying which delivery system actually receives preferred treatment is a more complicated matter than simply identifying the one in which receipts are likely to be excluded, since, as this article will explore below, the tax treatment of activity associated with the receipt may be at least as important as the receipt itself.

It is clear that administrative practice under the general welfare doctrine has an effect on the terms and methods by which transfer payments are made. See, e.g., LynDee Wells, 2006 Legal Symposium, National Indian Housing Council: Tax Treatment of Benefits to Tribal Members—General Welfare Programs (2006).

5. This decision makes the classification of the general welfare doctrine as a tax expenditure problematic:

The normal baseline, generally used by the Joint Committee on Taxation, would treat the exemption of all transfer payments from the government to private individuals as a tax expenditure in part because these “gifts” are mandated, open-ended government spending programs and not voluntary transfers from the government to individuals.

However, under the reference tax rules used by the executive branch, gross income does not include gifts, which are defined as receipts or money of property without compensation. Thus, under the reference baseline, most government transfer payments, which can be viewed as gifts from the government, are not considered tax expenditures. However, the reference baseline would consider the exemption of social security benefits a tax expenditure, as this transfer payment is associated with past employment Neither the reference baseline nor the normal baseline would consider the exclusion of gifts between individuals to be a tax expenditure.

Emil Sunley, *Tax Expenditures in the United States: Experience and Practice*, in TAX EXPENDITURE TREATMENT OF TRANSFER PAYMENTS, FROM TAX EXPENDITURES—SHEDDING LIGHT ON GOVERNMENT SPENDING THROUGH THE TAX SYSTEM 155, 162 (Hana Polackova Brix et al. eds., 2003).

6. Such exclusions become more problematic for lower-income taxpayers when traditional income tax measures are used to determine eligibility for social welfare programs, including the earned income credit. In such situations, the failure to include the value of

stem from the fact that these exclusions have only recently been made a part of the Code. Even then, the exclusions have only been partly incorporated.⁷

For decades, the Internal Revenue Service and its predecessor simply ruled that, as an administrative matter, certain transfers, including Social Security and unemployment payments, were not considered income.⁸ These ruling positions were relatively unproblematic when the majority of the situations in which payments were made depended upon an evaluation of the recipient's relative need and were intended primarily to meet the transferee's immediate consumption needs.⁹

Recent changes in attitudes toward, and approaches to, social welfare programs have put considerable strain on the doctrines under which transfer payments might be excluded. Payments under newer programs are more likely to be available before need is acute and to be aimed at establishing self-sufficiency instead of providing after-the-fact relief. Indeed, more programs are likely to be designed in ways that provide payments not directly to the intended beneficiaries of programs, but instead

government services—even public transportation—is far more likely to effect conclusions about the relative neediness of different groups of low income taxpayers. Furthermore, there may well be tension created in the applications of the doctrines justifying exclusion when exclusion can result in limitations on the availability of the earned income credit. See, e.g., I.R.S. Notice 99-3, 1999-1 C.B. 271. There, Temporary Aid to Need Families ("TANF") payments were excluded under the general welfare doctrine. Apparently they were already not income for Earned Income Tax Credit ("EITC") purposes under I.R.C. § 32(c)(2)(B)(v) (West 2006) (as added by Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1085(c), 111 Stat. 788, 956).

The literature contains surprisingly few systematic treatments of this aspect of the issues addressed here. Notable exceptions include Anne Alstott, *The Earned Income Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 572 (1995); and William Klein, *The Definition of "Income" Under a Negative Income Tax*, 3 FLA. ST. U. L. REV. 449 (1974).

7. See I.R.C. § 139 (2004), added by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, § 111, 115 Stat. 2427, 2432 (2002).

8. I.T. 3194, 1938-1 C.B. 114; I.T. 3229, 1938-2 C.B. 136; I.T. 3230, 1938-2 C.B. 136; I.T. 3447, 1941-1 C.B. 191; and Rev. Rul. 55-652, 1955-2 CB 21. This body of authority was confirmed in Rev. Rul. 70-217, 1970-1 C.B. 13 (dealing with miscellaneous portions of I.R.C. § 202(a) of Title II). Section 86, introduced by the Social Security Amendments of 1983, now provides a formula for including a portion of Social Security payments in income. A listing of many such non-statutory rulings is included as an appendix to the concurrence of Justice Frankfurter in *United States v. Kaiser*, 363 U.S. 299, 317-27 (1960), with the apparent assumption that such rulings should be viewed as binding precedent with the force of law.

9. As a political phenomenon, the evolution of the general welfare doctrine may at first seem a bit anomalous: its benefits were bestowed on a broad range of citizens, who were not likely able to mobilize to obtain it. The benefits, furthermore, have been taken away in relatively salient Congressional actions. Perhaps this evolution is best explained by the fact that its benefits were originally bestowed by an agency that was taking the position least likely to provoke any reaction at all. As of 2004, the doctrine and its related codifications had become politically salient only twice. Perhaps the most notable was the decision to tax a portion of Social Security under I.R.C. § 86. On one occasion, its benefits were denied to non-union strikers (who nevertheless were held entitled to gift treatment by the courts). See *Kaiser*, discussed *infra* note 19. On another occasion, the IRS appeared to encroach on the extent of the benefits available to veterans and clergy under related codifications, and those affected by auxiliary rules regarding receipts, discussed *infra* notes 37-48 and accompanying text.

to business taxpayers as an inducement to ameliorate a situation that might otherwise produce acute needs among individuals in the future. Such programs do not easily fit within the traditional approaches to determining the excludability of transfer payments. And because newer types of transfer payments are less likely to be limited to amounts intended for immediate consumption, they fit even less well with the doctrines used to ascertain the ancillary tax consequences of expenditures that might arguably be associated with such payments. Nascent changes in approaches to interpretation of the Code are likely to exacerbate these problems, since the ad hoc administrative approach historically invoked to exclude many types of government transfer payments does not easily fit with even a moderately literalist approach to interpreting the Code.

The problems encountered in accommodating such programs within the income tax have generally been neglected, both in the tax literature and in the literature exploring the shape that government relief and welfare programs might take.¹⁰ The provisions of new I.R.C. § 139 as initially enacted in 2001, and as amended in 2005, illustrate the problems inherent in establishing the appropriate approach to exclusions for transfer payments. This article will, in Part I, review the history of the relevant doctrines on which exclusions have historically been based; in Part II, consider the newer circumstances in which such doctrines and related codifications are to be applied; and in Part III, offer some recommendations for the future.

The paper ultimately concludes that the appropriate solutions depend in large part upon setting priorities among the various possible criteria that might be used in defining the contours of the income tax base. If maintaining a maximally comprehensive tax base in order to further progressivity is of ultimate importance, then the traditional approach both to the grounds for exclusion, and to the ancillary consequences of exclusion, should remain in place. But if other priorities are acknowledged, including either a notion of income commensurate with total value added to the economy, or the notion that Congress actually intended to provide tax benefits more substantial than simple timing in granting certain exclusions, many aspects of the current approach should be rethought. Similar choices among priorities would have to be made were

10. For instance, in the more-than-600-page symposium on disaster relief in response to September 11 published by the DePaul Law Review, only one author, Janet Cooper Alexander, *Procedural Design and Terror Victim Compensation*, 53 DEPAUL L. REV. 627 (2003), mentioned the tax relief measures enacted by Congress or adopted by the IRS. Only one other law review author has included discussion of the tax provisions in an analysis of disaster relief generally. See John G. Culhane, *Tort, Compensation, and Two Kinds of Justice*, 55 RUTGERS L. REV. 1027 (2003). And only one has focused on the tax aspects of disaster relief. See Francine Lipman, *Anatomy of a Disaster Under the Internal Revenue Code*, 6 FLA. TAX REV. 953 (2005). Even after the 2001 enactment of § 139, the topic seems not to have been particularly salient in the world of legal academic tax, as the provision was not always included in abridgements of the Code aimed at use in law schools. See, e.g., FEDERAL INCOME TAX: CODE AND REGULATIONS SELECTED SECTIONS (Martin B. Dickinson ed., 2002).

the income tax altered to even more closely approximate a consumption tax, or if it were entirely replaced by a consumption tax.

PART I: THE COMMON-LAW-LIKE ORIGINS OF THE EXCLUSION FOR TRANSFER PAYMENTS

A. THE DOCTRINAL GROUNDS FOR EXCLUSION

As originally explicated, the exclusion for transfer payments could have simply been understood as an interpretation of the provisions under which the transfer payments were authorized: absent an indication to the contrary, payments to be made by the federal government were not to be included in income unless specifically included.¹¹ The logic here would be essentially that Congress authorized payments at certain levels, and that the prescription of these levels essentially preempts the operation of any other federal statute that might be seen as reducing these levels. Under this rationale, similar payments authorized by other governments need not be exempt.¹² But the administratively generated doctrine was rather casually extended well beyond this, to payments authorized, administered, and funded only under state law, when such payments were made out of "general welfare funds."¹³

11. *E.g.*, Rev. Rul. 54-190, 1954-1 C.B. 46 (receipt of federal payments by unemployed federal employees); Rev. Rul. 68-38, 1968-1 C.B. 446 (area redevelopment payments under Title II-A of Economic Opportunity Act of 1964, Pub. L. No. 88-452, 78 Stat. 508 (Area Redevelopment) and under the Manpower Development and Training Act of 1962, Pub. L. No. 87-415, 76 Stat. 23); Rev. Rul. 63-136, 1963-2 C.B. 19 (payments made to individuals undergoing training or retraining under either the Area Redevelopment Act or the Manpower Development and Training Act of 1962); Rev. Rul. 70-341, 1970-2 C.B. 31 (receipt of Medicare); Rev. Rul. 71-425, 1971-2 C.B. 76 (modifying Rev. Rul. 67-144, 1967-1 C.B. 12, which allowed receipt of payments for work assignments under Title V of the Economic Opportunity Act of 1964, noting that payments were based primarily on need, not on work performed); Rev. Rul. 73-87, 1973-1 C.B. 39 (allowing receipt of experimental welfare payments funded by the Office of Economic Opportunity); Rev. Rul. 1976-229, 1976-1 C.B. 19 (payments to those displaced by foreign jobs); I.R.S. Priv. Ltr. Rul. 74-0528-0230A (May 28, 1974) (payments received under 42 U.S.C. § 630 (1971), establishing incentives for training of families with dependent children, including payments for child care for three months after participant has left the training).

12. See, for example, the rationale offered in I.R.S. Priv. Ltr. Rul. 55-08-12-5320A (Aug. 12, 1955) (holding, prior to the decision in *United States v. Kaiser*, 363 U.S. 299 (1960), that strike benefits were includible in taxable income) and in I.R.S. Gen. Couns. Mem. 36,470 (Oct. 31, 1975) (exploring the various possible rationales for Rev. Rul. 74-205 1974-1 C.B. 20). See also Rev. Rul. 57-1, 1957-1 C.B. 15. This approach may explain, for instance, the reluctance to treat foreign payments in the nature of social security on the same basis as domestic social security payments. See, *e.g.*, Rev. Rul. 62-179, 1962-2 C.B. 20 (Old Age Security Act of Canada to Canadian citizens residing in the United States); Rev. Rul. 66-34, 1966-1 C.B. 22 (similar payments to German residents taxable); Rev. Rul. 76-121, 1976-1 C.B. 24 (similar payments from the United Kingdom taxable). The published rulings contain no rationale distinguishing foreign and domestic old age pensions.

13. See, *e.g.*, Rev. Rul. 74-153, 1974-1 C.B. 20 (assistance to adoptive parents, on showing of need); Rev. Rul. 74-74, 1974-1 C.B. 18 (payments, based on need, from state crime victims compensation board, not taxable). The departure from justifications that could be seen as simply statutory construction arguments appears to have been first noted in I.R.S. Gen. Couns. Mem. 36,470 (Oct. 31, 1975):

[I]t is clear that the Service has developed a general welfare exclusion that goes beyond the mere act of Congress in exempting specific federal disburse-

This “general welfare doctrine” eventually came to be limited in four important respects. First, it was limited to those programs that were based on the recipient’s need.¹⁴ Although not all early rulings stated the requirement explicitly, those that did not could be explained as having accepted a presumption regarding need, based on the other criteria for qualification. For instance, payments made only to the blind or to the unemployed could easily be assumed to be at least roughly based on need.¹⁵ Second, the doctrine was unavailable for those programs that involved payments that depended in any significant way on the recipient’s

ments and which can therefore be invoked with respect to payments under state law, such as those in issue here. In other words, the Service recognizes a nonstatutory exemption for general welfare payments that can be applied to governmental expenditures that are either federal or nonfederal in origin.

Rev. Rul. 57-102, 1957-1 C.B. 26 (payments to blind excludible under the Public Assistance Law of the Commonwealth of Pennsylvania, 62 PA. STAT. ANN. § 2509 (West 1956)) seems to include the first published reference to “general welfare” as a criterion for exclusion.

Some early positions may have reflected the attraction of avoiding difficult questions regarding the application of doctrines involving intergovernmental tax immunity. Before 1938, it was not clear that the federal government could impose even nondiscriminatory income taxes on the compensation paid to state employees. See *Helvering v. Gerhardt*, 304 U.S. 405, 424 (1938) (holding that the federal government could tax the salaries of employees of the Port of New York Authority). Even after 1938, the extent of the doctrine, as applied to taxes that arguably could impede the governmental activities of a state, was unclear. See *South Carolina v. Baker*, 485 U.S. 505 (1988). And even if the constitutional authority to impose federal taxes on state governmental activities was clear, the legitimacy of such impositions remained unclear as a political matter.

Another factor that undoubtedly contributed to the extension of the doctrine to payments made by state and local governments is the difficulty that might ensue in distinguishing between programs that were in fact federal programs, and programs that were more appropriately viewed as state programs, using funds provided by the federal government but without binding federal constraints on their contours. See, e.g., Rev. Rul. 63-136, 1963-2 C.B. 19 (payments of federal funds made by states to individuals under the Area Redevelopment Act or the Manpower Development and Training Act of 1962 were not included in their gross income).

14. See, e.g., Rev. Rul. 85-39, 1985-1 C.B. 21 and Rev. Rul. 76-131, 1976-1 C.B. 16 (payments made by the State of Alaska under the Alaska Longevity Bonus Act to long-term residents distinguished from general welfare payments because they were based on the recipient’s age and residency). This holding was implicitly endorsed in *Greisen v. United States*, 831 F.2d 916 (9th Cir. 1987), cert. denied, 485 U.S. 1006 (1988), although in this case the court was not asked to consider the general welfare doctrine as such. See also Rev. Rul. 80-330, 1980-2 C.B. 29 (denying exclusion for payments received by taxpayers pursuant to the National Historic Preservation Act of 1966, and distinguishing Rev. Rul. 76-395, 1976-2 C.B. 16 (excluding home rehabilitation grants received under the Housing and Community Development Act of 1974) (acknowledged as obsolete after the enactment of 16 U.S.C. § 470 by the Act of Dec. 12, 1980, Pub. L. No. 96-515, 94 Stat. 2987, specifically excluding such payments from income) and Rev. Rul. 76-144, 1976-1 C.B. 17 (excluding grants received under the Disaster Relief Act Amendments of 1974)).

15. Rev. Rul. 57-102, 1957-1 C.B. 26 (payments to blind excludible under the Public Assistance Law of the Commonwealth of Pennsylvania, § 2509). The IRS has recently expanded the scope of the doctrine from situations in which the exclusion is available on a program wide basis, thus making it applicable to all recipients, to situations in which the exclusion will be available only to certain groups of recipients within the same program. See, e.g., I.R.S. Priv. Ltr. Rul. 2004-09-033 (Feb. 27, 2004) (allowing an exclusion for those recipients of tribal education assistance with an income below the national median income level). This expansion may seem to some to push the development of the doctrine beyond the competence of the IRS, since it includes the use of an IRS-developed standard for need.

performance of services.¹⁶ Third, the doctrine was not available to the extent that payments were made to compensate the recipient for any specific loss to property.¹⁷ Finally, it was limited to payments made by governments and was held not to be available for payments by charities or individuals.¹⁸

The original motive and justification for such rulings is somewhat obscure. When announcing positions in support of the exclusion of general welfare payments in the most primitive early statements, the IRS and its predecessors invoked a number of concepts that have since developed into discrete doctrines, some but not all of which have been codified. For instance, early rulings contained a curious mix of return of capital and gift rationales.¹⁹ These rulings frequently addressed situations in which Code sections with a relative determinative scope now control, but whose facts may actually extend beyond the scope of the Code sections as currently interpreted. In such circumstances, should the Code section be read as entirely pre-emptive of its predecessor doctrines, or should it be read as confirmation of the core of the doctrine, with no implication for situations outside of its scope? Should the answer be different if the codifica-

16. *E.g.*, *Bannon v. Comm'r*, 99 T.C. 59 (1992); *Meyer v. Comm'r*, 68 T.C.M. (CCH) 1037 (1994) (*Bannon* is not applicable where the recipient parent is not performer of services); *May v. Comm'r*, 65 T.C.M. (CCH) 2063 (1993) (following *Bannon*); I.R.S. Chief Couns. Adv. Mem. 2002-27-003 (July 5, 2002) (denying exclusion for reductions in property taxes otherwise owed by senior citizens in exchange for community service). The fact that a payment is loosely tied to prior services has not prevented the doctrine's application to unemployment benefits. *See Rev. Rul. 55-652, 1955-2 C.B. 21.*

17. The IRS has allowed the doctrine to be applied when the payments are made as reimbursement for particular expenditures. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2004-51-022 (Dec. 17, 2004) (reimbursements to families with a debilitatingly disabled member for various extraordinary living costs).

18. This limitation alone was rarely sufficient to render any payments taxable, since the exclusion for gifts would generally be available. *See, e.g.*, I.R.S. Special Rul., 1952, 1952-5 Standard Fed. Tax Rep. (CCH) 6196 (May 11, 1952). The general welfare doctrine has, however, been applied in some circumstances in which gift treatment is problematic and, in recent years, has been treated as available even though the gift exclusion might not be available. *See infra* notes 29-36 and accompanying text.

19. *See, e.g.*, Sol. Op. 132, I-1 C.B. 92 (1922) (damages for alienation of affections or for defamation are excludible, and suggesting that such a conclusion is constitutionally compelled by the analysis in *Eisner v. Macomber*, 252 U.S. 189, 218 (1920)); I.T. 1804, II-2 C.B. 61 (1923) (damages for breach of promise to marry not excludible from gross income); I.T. 2420, VII-2 C.B. 123 (1928) (payment made to taxpayer for the death of her husband on the *Lusitania* excludible); Rev. Rul. 131, 1953-2 C.B. 112 (combining the gift and the no-better-off return of capital rationale to exclude tornado-relief payments from a corporation to its own employees).

The gift rationale for some relief payments, codified in § 102 of the 1954 Code, survived challenge in *United States v. Kaiser*, 363 U.S. 299 (1960) (allowing strike benefits paid to workers who were not union members to be treated as gifts, although under longstanding administrative positions similar payments to members were taxable), a decision which has never been repudiated. *Kaiser* was argued and decided the same day as the case most often cited as precedent for a limited reading of the exclusion for gifts, *Duberstein v. Commissioner*, 363 U.S. 279 (1960). However, many payments that might have been considered under the early articulations of the gift rationale have since been expressly included (see, for example, the inclusion in I.R.C. § 74 of prizes and award, and the limitations excluding scholarships in I.R.C. § 117).

The fate of the return of capital rationale is less clear.

tion seems to have extended the doctrine to some fact pattern previously considered outside the scope of the doctrine, without including other fact patterns well-established as within the doctrine's scope? Very little effort seems to have been made to determine the relationship between such codifications and their predecessor administrative doctrines.

This administratively-based exclusion under the general welfare and related doctrines has historically not been available to payments made to businesses, even when the payments are clearly disaster related.²⁰ This undoubtedly reflects the importance of the need-based criteria in the evolution of the doctrine, since the presumption of relative need may be far less appropriate with respect to aid to businesses than it is with respect to aid to individuals. It also reflects the fact that most such payments to businesses historically involved replacement for specific losses. Most of the older authorities involve payments (or debt relief) that relate specifically to particular damaged properties. In such cases, it appears to have been easily concluded that the relief payments received should not be excluded, but should be treated as payments in the nature of a compensation for the loss of the property.²¹

Despite the lack of an exclusion for the amount of the payments, recipients of payments for specific losses do not always fare unfavorably. First,

20. The doctrines discussed in the text may overlap in some situations with the exclusion that applies to non-shareholder contributions to capital, now substantially codified in §§ 118 and 361(c). For an excellent review of these authorities, and the tension inherent in the denial by the IRS of similar treatment for contributions to non-stock and pass-through entities, see Kimberly Blanchard, *The Taxability of Capital Subsidies and Other Targeted Incentives*, 85 TAX NOTES 781 (1999). In general, this doctrine will involve the same exclusion-with-no-subsequent basis result discussed *infra* note 37 and accompanying text.

There are, however, a few instances in which the IRS has been willing to exercise some discretion in applying administrative doctrines to exclude non-cash transferable values received by businesses. In Rev. Rul. 67-135, 1967-1 C.B. 20, an exclusion was allowed to the winner of a lottery for below market rental of oil and gas properties, and in Rev. Rul. 92-16, 1992-1 C.B. 15 (excluding emission allowances granted under Title IV of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2399). These two rulings have been cited by the IRS as authority for the proposition that "the granting of a transferable right by the government does not cause the realization of income." See for example, I.R.S. Priv. Ltr. Rul. 2005-23-035 (Dec. 2, 2004), and several dozen other private letter rulings issued since 1992. Some such situations actually involved circumstances similar to bargain purchases. See, e.g., I.R.S. Gen. Couns. Mem. 39,606 (Feb. 27, 1987) (holding that no income resulted from the granting of airport landing rights). But many of the holdings have not been so limited.

21. Such payments historically have had the same effect as payments from private insurers: the payment (if received or anticipated in the year of the casualty) reduces casualty loss claimed or results in tax benefit income if deducted then received in a later year. See, e.g., Rev. Rul. 71-160, 1971-1 C.B. 75 (loan forgiveness under the Disaster Relief Acts of 1969, Pub. L. No. 91-79, 83 Stat. 125 and 1970, Pub. L. No. 91-646, 84 Stat. 1894). Amounts in excess of basis will produce casualty gain. Casualty gain can be avoided by reinvesting any proceeds and making an election under § 1033. I.R.S. Chief Couns. Adv. Mem. 1999-19-020 (May 14, 1999) (grants to those suffering flood damage in city-administered program funded under Pub. L. No. 105-18, 111 Stat. 158 (1997)). This same treatment will apply when the payment takes the form of forgiveness of a disaster loan. See, e.g., *Shanahan v. Comm'r*, 63 T.C. 21, 26 (1974) (reducing amount of deduction when debt relief in same year as casualty loss); *Londagin v. Comm'r*, 61 T.C. 117, 125 (1973) (requiring tax benefit income when forgiveness related to prior casualty loss claimed). In both cases, the court accepted the IRS loan forgiveness in Rev. Rul. 71-160, 1971-1 C.B. 75.

many qualify to take advantage of provisions under I.R.C. § 1033, to avoid income on the gain involved in situations construed to involve forced sales of property. For these taxpayers, receipts for specific losses do not trigger current income, so long as replacement property is acquired, although at a cost of the denial of basis for the amount received and reinvested.²²

Still other government transfer payments to businesses do not qualify for nonrecognition under I.R.C. § 1033 because they are not intended as reimbursements for specific losses. Many such payments are intended as subsidies to accomplish goals that would not otherwise be adequately attractive financially from the taxpayer's private point of view, especially when those goals relate to future economic development or to conservation improvements. Although the IRS has frequently concluded that such payments should be fully taxable,²³ it, along with the courts and Congress, has found grounds for exclusion in certain cases. Some rulings, for instance, have concluded that the taxpayer simply did not have sufficient dominion over the funds in question to require inclusion in income, given the limitations imposed on the funds' use.²⁴ Such payments could

22. Generally, § 1033 provides nonrecognition only when the taxpayer reinvested specifically in property "similar or related in service or use" to the destroyed property within two years, and denies basis for the use of the proceeds. Section 1033(h), added in § 13431(a) of the Omnibus Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, relaxes this standard such that no replacement at all is required with respect to personal property not separately scheduled under the taxpayer's insurance. Section 1033(h)(1)(A)(i) provides that "no gain shall be recognized by reason of the receipt of any insurance proceeds [for non-scheduled property]." The statute contains no reference to a replacement requirement, or to a limitation on basis or deductions for the use of the proceeds. Although these omissions make this "nonrecognition" provision unusual, in that the taxpayer is not limited in the use of the proceeds, this result is consistent with the stated intentions of its legislative sponsor, to "[allow] taxpayers to replace 'normal household property' with a minimum of record keeping." 139 Cong. Rec. S1593-01 (statement of Sen. Feinstein, on the introduction of S. 364). All other proceeds related to the personal residence and its contents may be considered as related to a single property, which consists of both the residence and its contents, for the purposes of the replacement requirements.

23. Rev. Rul. 60-31, 1960-1 C.B. 23 (including in payments and cost-sharing benefits attributable to the acreage reserve program and the conservation reserve program of the Soil Bank Act, Title I of the Agricultural Acts of 1956, 7 U.S.C. § 1801 (repealed 1965)). I.T. 3379, 1940-1 C.B. 16 (1940); I.T. 2993, XV-2 C.B. 75 (1936); I.T. 2767, XIII-1 C.B. 35 (1934). Some rulings simply held that such payments reduce casualty losses that can be claimed, a result that implies that the amount would be includible in income, and ignoring the limitations that apply to personal casualty losses and possible mismatches of character, produces the same result as inclusion in income.

24. *Bailey v. Comm'r*, 88 T.C. 1293, 1299-1301 (1987) (holding urban development grant not includible for lack of control); Rev. Rul. 77-280, 1977-2 C.B. 14 (allowing exclusion for payments to foster parents where such payments were in the nature of reimbursements for expenditures, but denying deductions therefor; results altered by enactment of the Periodic Payment Settlement Act, Pub. L. No. 97-473, 96 Stat. 2606 (1983), (amended in 1986)). Some of these authorities have focused on the availability of a deduction for the use of the proceeds, having assumed the excludability of the payment. *Wolfers v. Comm'r*, 69 T.C. 975 (1978) (no deductions for payments resulting from receipts under Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, Pub. L. 91-646, 84 Stat. 1894 (1971), excluded under section 216 of that act); see also Rev. Rul. 78-388, 1978-44 I.R.B. 6, considered in I.R.S. Gen. Couns. Mem. 37,293 (July 1978) (same facts, but emphasizing the lack of deductibility given reimbursement); Rev. Rul. 79-263, 1979-2 C.B. 82 (allowing exclusion but denying deduction for payments made under the Federal Disas-

be considered as having been made to the taxpayer as an agent of the government, or, at worst, as having been made loans for specific purposes that must be repaid only if not used for those purposes. This approach was codified with respect to certain types of cost-sharing payments in I.R.C. § 126.²⁵

The net effect of both of these approaches—the explicit nonrecognition under I.R.C. § 1033, and the no-receipt approach embodied in I.R.C. § 126—is a deferral of income recognition. There is no income at the time of the receipt, but there is also no basis to reduce income at the time any return resulting from investment of the receipt is enjoyed. The value of this treatment depends upon when the foregone basis might have been available to offset other income.²⁶ Suppose a taxpayer faces a 15% tax rate in the year that the payment is received, ordinarily uses a 4% after-tax discount rate to evaluate future projects, and plans to sell the property enhanced by the expenditure of the payment in three years. The taxpayer in this situation has qualified for a tax benefit with a present value of 15, but has in the process given up a tax benefit with a present value of about 13 (the value of an offset to the amount realized in the third year, at a 15% tax rate, assuming a 4% discount rate). If the re-

ter Assistance Administration's Emergency Livestock Feed Assistance Program, authorized by section 305 of the Disaster Relief Act of 1974, 42 U.S.C. § 5145 (1976), and analyzed in I.R.S. Gen. Couns. Mem. 37,920 (Apr. 1979)). This approach had not always been accepted. See *Lykes Energy v. Comm'r*, 77 T.C.M. (CCH) 1535 (1997) (holding that a gas company may not exclude amounts collected from customers and devoted to specific energy-saving programs under a state-sponsored program).

The IRS and the courts have not always been so generous, and not all of the positions taken over time are reconcilable. Compare *G.A. Stafford & Co. v. Pedrick*, 171 F.2d 42 (2d Cir. 1948); *Baboquivari Cattle Co. v. Comm'r*, 135 F.2d 114 (9th Cir. 1943), *aff'g* 47 B.T.A. 129 (1942) (cited as still-binding precedent in *Berglund v. Commissioner*, 70 T.C.M. (CCH) 1274 (1995)), with cases cited *supra* note 23.

A handful of authorities apply a gift theory even to government payments. See, e.g., *United States v. Hurst*, 2 F.2d 73, 80 (D. Wyo. 1924) (holding that minerals rights acquired through statutory procedures were in the nature of a gift and not taxable income; *Hurst* was decided when there was considerable confusion about the appropriate rules for taxing income from mineral extraction, especially given the political pressure to avoid taxation of pre-1913 values). The IRS appears to have totally repudiated the possibility of excluding government transfer payments as gifts.

25. Revenue Act of 1978, Pub. L. No. 95-600, § 543(a), 92 Stat. 2763, 2888-90. The exclusion is to be available only to the extent that such payments are determined to serve the designated conservation-related functions, and to not "increas[e] substantially the annual income derived from the property." *Id.* § (b)(2). The calculation of the amount to be included in income in situations in which the latter condition is not met with respect to the entire payment is set out in the regulations, and takes into account only the net increase in the value of the property in question.

As initially enacted, the provision made clear that no basis would be available and contained a special recapture rule in new I.R.C. § 1255, requiring sale proceeds to be treated as ordinary income to the extent attributable to excluded amounts.

26. Compare the proposal for the taxation of transactions within certain very-small scale barter communities, Vada Waters Lindsey, *The Burden of Being Poor: Increased Tax Liability? The Taxation of Self-Help Programs*, 9 KAN. J.L. & PUB. POL'Y 225 (1999) (arguing that certain community barter programs, sometimes called "time dollar" programs, should not produce taxable income, but conceding that retransfers of such values should be treated as sale of zero basis property, following *Charley v. Commissioner*, 91 F.3d 72 (9th Cir. 1996)).

placement property would have been eligible for cost recovery as three-year property, the alternative tax benefit from the resulting deductions would have been even higher, with a present value of 14.4. The slim margin between the benefit of outright exclusion and the benefit of cost recovery could easily be eliminated, if the foregone cost recovery were available to reduce income at a higher bracket in the later year.

Viewed in this way, the primary taxpayer's advantage from the exclusion with denial of basis in many cases is likely to be avoiding cash-flow problems, with only a negligible reduction in overall tax liability.²⁷ Indeed, if the taxpayer is in a higher bracket in the years after the payment is received, the exclusion at the lower rate in the first year may have less value than the use of basis at a higher rate in the later years, even after taking into account the discount for the delay in the use of basis.²⁸

In summary, the general welfare doctrine's scope has been substantially limited since its first articulation. Many types of payments previously excluded only under administrative practice are no longer excluded (unemployment under § 85), only partially excluded (Social Security under § 86), or are excluded under specific Code provisions. But it remains an anomaly, not fitting well with any rigorous theoretical concept of income and without statutory articulation to provide its scope in the absence of a conceptual justification.

B. THE PROBLEMS CREATED BY INCOMPLETE SPECIFICATION OF THE GENERAL WELFARE DOCTRINE

Commentators disagree about what to make of those aspects of the discussion that rely only on administrative practice, unsupported by any statutory language. Is such practice part of the tax law doctrine, with some force of precedent or simply an administrative practice, like the prosecutor's discretion not to arrest and prosecute all those who jaywalk?

The leading introductory casebooks on taxation reflect this confusion. Some seem to ignore administrative doctrine completely.²⁹ Others treat

27. In many circumstances, this same reduction in overall tax liabilities is appropriately a matter of significant concern in tax base design. But in the situations under consideration here, in which taxpayers are unlikely to be able to plan to take advantage of them, it seems likely that other considerations, including the benefit to be obtained through the granting of tax benefits in the particular context, ought to outweigh concern for a perfectly rational tax base design.

28. Not surprisingly, not long after the enactment of I.R.C. § 126, at least some of its beneficiaries came to realize that exclusion can produce a net tax detriment. The Technical Corrections Act of 1979, Pub. L. 96-222, § 105(a)(7)(a), 94 Stat. 194, 220 (1980), added § 126(b), making the exclusion offered by § 126(a) elective. The legislative history indicates that a tax detriment could arise, compared to the prior law wash of income and immediate deduction in appropriate circumstances, because of the strict recapture rule in § 1255. A net detriment from exclusion could also arise as a result of the effect of the exclusion/no basis on the operation of the investment credit and net operating loss limitations. S. REP. NO. 96-498, at 79-80 (1979), 1980-1 C.B. 517, 554-55.

29. For instance, MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 215 (5th ed. 2005) simply mentions, under the heading "September 11 Tax Provisions", that "Congress occasionally chooses to provide special tax benefits," and proceeds to describe the provisions of I.R.C. § 139, without reference to

its invocation as a rather quaint historical practice.³⁰ Only a few treat the phenomenon as more than an aberration.³¹ Only a handful of discussions of the doctrine appear in law review literature.³² One recent commentator simply concluded, without elaboration, that “[t]he doctrine and the policy behind it seem simple: It doesn’t make sense for the government to tax government-provided assistance payments. . . . The general welfare doctrine is an administrative exclusion, the application of which is subject to IRS discretion.”³³

The viability of the doctrine is further complicated by the many instances in which Congress has expressly specified that certain payments, very similar to those that might be excluded under the doctrine, should be excluded. Some such provisions find their way into the Code;³⁴ some are

its “common-law” origins. For only a discussion of § 139, not its “common-law” antecedents, see SAMUEL A. DONALDSON, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, 322-23 (2004).

Similarly, Bittker and Lokken seem not to have mentioned the practices in the original masterwork, and rather misleadingly, associate it with the exclusion of gifts under I.R.C. § 102. BORIS I. BITTKER & LAWRENCE LOKKEN, *1 FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 110.2.5 (3d ed. 1999).

Some authors confront the problem of administrative exclusions for values that might seem too insignificant to be worth the technical or practical problems associated with including them in income, for instance barter and imputed income, but do not mention the closely associated problems inherent in dealing with government services and transfer payments. See, e.g., JOEL S. NEWMAN, *FEDERAL INCOME TAXATION: CASES, PROBLEMS AND MATERIALS* (3d ed. 2002) (although upfront treatment of imputed income, no mention of transfer payments); MICHAEL A. LIVINGSTON, *TAXATION: LAW, PLANNING, AND POLICY* 48-54, 63-68 (2003), includes a discussion of *United States v. Kaiser*, 363 U.S. 299 (1960), and taxation of reparations payments.

30. Klein and Bankman include common law origins of § 104, but do not mention other administrative exclusions. WILLIAM A. KLEIN & JOSEPH BANKMAN, *FEDERAL INCOME TAXATION* 214 (10th ed. 1994).

31. For instance, PAUL R. MCDANIEL, MARTIN J. MCMAHON, DANIEL SIMMONS & ALICE G. ABREU, *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 146-53 (5th ed. 2004) includes a full discussion of taxability of business subsidies and administrative general welfare doctrines relating to need-based payments. This work acknowledges the difficult line between in-kind and cash receipts, but, emphasizing the progressivity aspects, concludes all cash should be taxable even if exclusions continue for non-cash transfer payments. Even this treatment is greatly abbreviated from the attention given the doctrine in its predecessor. STANLEY SURREY, WILLIAM WARREN, PAUL MCDANIEL & HUGH AULT, *FEDERAL INCOME TAXES: CASES AND MATERIALS* 214-16, 294-98 (1972).

Of the casebooks currently in print, it appears that only JOSEPH M. DODGE, J. CLIFTON FLEMING & DEBORAH GEIER, *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY: TEXT, CASES, PROBLEMS* (3d ed. 2005) includes a discussion that attempts to rationalize this body of law.

32. Charlotte Crane, *Matching and the Income Tax Base: The Special Case of Tax Exempt Income*, 5 AM. J. TAX POL. 191 (1986); Theodore P. Seto & Sande Buhai, *Tax and Disability: Ability to Pay and the Taxation of Difference*, 154 U. PA. L. REV. 1053 (2006) (noting that the doctrine does not fit well under standard tax theory but might nevertheless be justified because, if there were an adequate zero-bracket amount, most payments excluded under the general welfare doctrine would be exempt).

33. Robert W. Wood & Richard C. Morris, *The General Welfare Exception to Gross Income*, TAX NOTES TODAY, Oct. 4, 2005, LEXIS, 2005 TNT 191-34.

34. Most interesting, perhaps, is I.R.C. § 134, which provides that no military benefit provided in the future is to be excludible unless the benefit is expressly mentioned in the Code:

Notwithstanding any other provision of law, no benefit shall be treated as a qualified military benefit unless such benefit [was excluded under prior prac-

codified outside of the Code,³⁵ still others are never codified at all. There seems to be virtually no pattern to these practices, and very little to be learned from them about the Congressional view of the general welfare doctrine. Nevertheless, both Congress (in legislative history) and the courts (in dicta) have acknowledged the doctrine without questioning its role in the overall structure of the tax base.³⁶

... is excludable from gross income under this title without regard to any provision of law which is not contained in this title and which is not contained in a revenue Act.

I.R.C. § 134 (West 2006). To this author's knowledge, more recent Congresses have not acted in a way that would challenge the effectiveness of this provision. It appears that Congress has taken the provision seriously, since in 2004 it added § 134(b)(5) to ensure that travel enjoyed under the Operation Hero Miles program, 10 U.S.C. § 2613, would not be taxed. See I.R.C. § 134(b)(5).

35. Typical is 42 U.S.C.S. § 8624(f)(1) (West 2006), which prevents payments received under the Low-Income Home Energy Assistance Act of 1981, Title XXVI of the Omnibus Budget and Reconciliation Act of 1981, Pub. L. No. 97-35, 95 Stat. 357, from being included in other measures of income:

Notwithstanding any other provision of law unless enacted in express limitation of this paragraph, the amount of any home energy assistance payments or allowances provided directly to, or indirectly for the benefit of, an eligible household under this title [42 USCS §§ 8621 et seq.] shall not be considered income or resources of such household (or any member thereof) for any purpose under any Federal or State law, including any law relating to taxation, food stamps, public assistance, or welfare programs.

Even when exclusion provisions are codified, further interpretation invoking the general welfare doctrine may be necessary. For instance, the IRS ruled that forgiveness of arrearages on utility bills, administered in conjunction with a program under which "payments" specifically covered by § 8624(f) were made, could be excluded, following Rev. Rul. 78-170, 1978-1 C.B. 24, in I.R.S. Priv. Ltr. Rul. 91-43-016 (July 19, 1991). Without the general welfare doctrine, the ruling would have been forced to consider whether such forgiveness technically could be construed either as "payments" (and thus excludable under the statute) or as "rebates" (and therefore not income under the uncodified general rule that bargain purchases are not income)

36. See, e.g., STAFF OF THE J. COMM. ON TAXATION, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS 194 (Comm. Print 2003); STAFF OF THE J. COMM. ON TAXATION, 96TH CONG. GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 158 (Comm. Print 1979) (explaining prior taxation of unemployment benefits). Congress has even made statutory reference to similar administrative practices in contexts in which one can only conclude that such common-law approaches were endorsed. In enacting I.R.C. § 134 in 1986, Congress expressly provided that any "qualified military benefit," defined to include any benefit that "was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date . . ." would remain excluded. I.R.C. § 134(b)(1).

On the other hand, the briefing papers of the Congressional Research Service have been inconsistent in their references to the doctrine. Compare PAMELA J. JACKSON, INCOME TAX RELIEF IN TIMES OF DISASTER, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS 5 (2005) (referring only to the payments covered by § 139, and stating that "disaster relief payments were originally excluded from income" by the enactment of that section in 2001), with VEE BURKE, WELFARE RECIPIENTS AND WORKFORCE LAWS, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS (2006).

In its description of the provisions of I.R.C. § 139, written after passage of its provisions in both the House and Senate, the Joint Committee included a description of the prior administrative practice under the general welfare doctrine, and even stated that income replacement payments would not be excludable under § 139, despite the fact that no language in the text need be read to include such a limit and the prior published guidance under the general welfare doctrine had not made the limitation explicit. STAFF OF THE J. COMM. ON TAXATION, 107TH CONG. TECHNICAL EXPLANATION OF THE "VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001," AS PASSED BY THE HOUSE AND THE SENATE ON DE-

C. THE ANCILLARY DOCTRINES

From the theory of exclusion that rests on the idea that the recipient never had control of any value that should have been included in the tax base, it seems fairly straightforward to conclude it appropriate to deny the taxpayer any basis credit or deduction for the way in which the value is spent after receipt. This result is the pattern generally codified in I.R.C. §§ 126 and 362(c). The situation is just one instance of the straightforward idea that a taxpayer cannot claim a deduction for an expenditure he never took into income, because if he were allowed to do so, we would reduce our assessment of his overall well-being by an amount that was never included.³⁷ Under this approach, it may seem appropriate in some circumstances to deny a taxpayer a deduction that would otherwise be allowed for an expenditure, when the receipt itself was conditioned on the fact that the expenditure was made, and the receipt itself was excluded.

The IRS enjoyed considerable success in developing this reasoning in a series of cases in the mid-1980s involving deductions claimed as business expenses by pilots who were receiving reimbursements therefor as a veterans' benefit. In developing its litigation strategy, however, it rather sloppily framed its arguments in two different ways. In addition to the no-control-reimbursement theory of *Bailey*, in some situations it relied on

CEMBER 20, 2001, JCX-93-01, at 16, 18 (2001). This point was strengthened, with no additional authority, in the General Explanation. STAFF OF THE J. COMM. ON TAXATION, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS 195 (Comm. Print 2003).

On court acknowledgment of the general welfare doctrine, compare *Goldman v. United States*, 79 F. Supp. 2d 1356 (N.D. Ga. 1998), *aff'd per curiam*, 196 F.3d 1262 (11th Cir. 1999) (payments from insurance to wife, for services in tending to disabled insured taxable) and *Bannon v. Commissioner*, 99 T.C. 59 (1992) (finding payments made to those providing services to needy family members had received income), with *Meyer v. Commissioner*, 68 T.C.M. (CCH) 1037 (1994) (citing *Bannon*, but with the government concession that there was no income because the payment was not contingent on the performance of services by the family member). See also *Bailey v. Comm'r*, 88 T.C. 1293, 1299-1301 (1987) (finding no income on other grounds); *Graff v. Comm'r*, 74 T.C. 743, 753 (1980), *aff'd per curiam*, 673 F.2d 784 (5th Cir. 1982) (finding income, but allowing deduction).

The Supreme Court seems also to have been untroubled by this administrative practice. See, e.g., *United States v. Kaiser*, 363 U.S. 299, 306-07 (1960) (Frankfurter, J., concurring). The Supreme Court, referring to a New York State low-income housing subsidy, acknowledged the doctrine in dicta in a case in which the ultimate question did not involve the presence of taxable income under the Code, but instead involved the possibility of profits under the securities laws: "In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies." *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 855 (1975).

It is difficult to decide what to make of the fact that the courts have never ruled in favor of a taxpayer based solely upon the application of the doctrine. Ordinarily, the courts do not have an opportunity to affirm IRS positions in favor of particular taxpayers, and the degree of deference that might be accorded to IRS positions in the event that the IRS deviated from long-standing practice in favor of taxpayers is unclear.

37. As basic as this proposition is to the income tax, it is not expressly stated in the Code (see *infra* note 69, explaining why provisions that generally deny double benefits are not, at least in this author's view, adequate articulations of this principle.) It is sometimes, but rarely, encountered in the case law. E.g., *Remy v. Comm'r*, 73 T.C.M. (CCH) 1976 (1997), *cf.* *Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975).

the language of I.R.C. § 265, that “[n]o deduction shall be allowed for . . . [a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest . . . wholly exempt from [income tax].³⁸ In *Mannocchio v. Commissioner*,³⁹ the Ninth Circuit adopted the result urged by the government⁴⁰ but embraced only the re-

38. I.R.C. § 265(a)(1) (2006). Although § 265 was renumbered by Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, its general text was not changed in any relevant way.

The predecessor of § 265 was first enacted in 1934. See generally The Revenue Bill of 1934, H. REP. NO. 73-704, at 571 (1934); S. REP. NO. 73-558, at 606 (1934).

39. 710 F.2d 1400 (9th Cir. 1983), *aff'g* 78 T.C. 989, 997 (1982).

40. *Id.* at 1404. Fact patterns essentially the same as that in *Mannocchio* were litigated in at least forty other reported cases, almost all of which agreed—without much analysis—with the ultimate outcome urged by the government. Those that balked did so primarily on the ground that the IRS had in fact changed its position after the facts involved in the case. See *Baker v. United States*, 575 F. Supp. 508 (N.D. Ga. 1983), *aff'd*, 748 F.2d 1465 (1984). Shortly after the *Baker* decision, the IRS reversed its position with respect to the retroactive repudiation of Rev. Rul. 62-213, 1962-2 C.B. 59 (1062) in Rev. Rul. 80-173, 1980-2 C.B. 60 (1980). See, e.g., *Masat v. Comm’r*, 784 F.2d 573, 574-75 (5th Cir. 1986). In 1993, legislation was introduced to extend the time period in which refund claims based on the reversed position could be filed even with respect to cases already decided by the Tax Court. H.R. 642, 103d Cong. (1st Sess. 1993). The government appears to have then conceded the issue. Rev. Rul. 80-173, 1994 FSA LEXIS 669. As late as 1999, the political dust stirred up by the *Mannocchio* position had not yet settled. See Press Release, Congresswoman Ellen O. Tauscher, Tauscher Announces Memorial Day Agenda, Introduces Bill To Reverse I.R.S. Penalty for Veterans (May 28, 1999), available at <http://www.house.gov/tauscher/press/5-28-99.htm>.

Indeed, this fact pattern and others involving veterans benefits, had vexed the IRS for a number of years. I.R.S. Gen. Couns. Mem. 31,671 (June 14, 1960), concluded that deductions related to all such military and veterans benefits be denied. I.R.S. Gen. Couns. Mem. 31,939 (Mar. 16, 1961), however, revoked I.R.S. Gen. Couns. Mem. 31,671 (June 14, 1960), and resulted in the publication of Rev. Rul. 62-213, 1962-2 C.B. 59, revoked by Rev. Rul. 83-3, 1983-1 C.B. 72, which allowed such deductions. I.R.S. Tech. Mem. 77-39-004 (June 24, 1977) held that the taxpayer subject to that ruling could rely on Rev. Rul. 62-213. In Rev. Rul. 80-173, 1980-2 C.B. 60, the IRS began to change its position and denied educational expense deduction for amounts related to 38 U.S.C. § 1677 payments on a reimbursement theory. Because this particular benefits statute required a closer connection between the tuition paid and the amount received, Rev. Rul. 62-213 could be satisfactorily distinguished. Shortly thereafter, the IRS took the next step in I.R.S. General Counsel Memoranda 38,948 (Dec. 27, 1982), and revoked I.R.S. Gen. Couns. Mem. 31,939 (this had been earlier “revoked” by I.R.S. Gen. Couns. Mem. 34,506 (May 26, 1971), but that memorandum seems not to have been followed) and held that no current deductions under I.R.C. § 162, 163, or 164 were available because of the limitation in I.R.C. § 265(1).

Issues relating to deductions based on amounts for which exemption under I.R.C. § 107 was available were sometimes considered in this same series of rulings. I.R.S. Gen. Couns. Mem. 28,843 (Mar. 25, 1958) had originally held that no deductions would be allowed for mortgage interest or property taxes directly reimbursed by exempt allowances, but was revoked by I.R.S. Gen. Couns. Mem. 31,939 (March 16, 1961). This position was made public in Rev. Rul. 62-212, 1962-2 C.B. 41. This result, like the result in the context of the military benefits in the above paragraph, was reversed in I.R.S. Gen. Couns. Mem. 38,948 (Aug. 21, 1981).

The systemic change was announced publicly in Rev. Rul. 83-3, 1983-1 C.B. 72. The triumph in *Mannocchio* and the announcement of Rev. Rul. 83-3 did not, however, bring an end to these issues. Congress intervened with section 1052 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, which directed that Rev. Rul. 83-3 be applied before January 1, 1986, at least with respect to taxpayers who already owned homes: the IRS responded in July 1985 with Rev. Rul. 85-96, 1985-2 C.B. 87, which indicated that the Service will not disallow such deductions before January 1, 1987. Section 144 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2121, added I.R.C. § 265(a)(6), and

imbursement theory, and not the general applicability of § 265, to deny basis for using excluded receipts in certain circumstances.

The application of § 265 in these cases involving reimbursement for particular expenditures has considerable intuitive appeal and produces essentially the same pattern as that provided for under the specific terms of I.R.C. § 126. It should be noticed, however, that denying the deduction will usually put the recipient taxpayer in exactly the same position that he would have been in had *no exclusion* been provided for the receipt. Again, if he is a taxpayer in the 15% bracket, and receives and spends \$100 in the same tax year, he will have received a tax benefit of 15 from the exclusion, but will have been denied a benefit of 15 from the § 162 expense.⁴¹

Is this “no-benefit” result inconsistent with the exclusion for the payments in the first place? To answer that question, one would need to know more than we are likely to know about the initial reasons for the exclusion. Perhaps it was simply to avoid the administrative and public relations problems inherent in attempting to tax a payment that is supposed to serve as reimbursement for another payment. Adjusting the reimbursement to take into account an approximation of the recipient’s tax liability is not an easily explained computation,⁴² and adjusting it to take into account the taxpayer’s actual tax liability would be an administrative disaster.⁴³ But if taxes are taken out of the reimbursement without an adjustment, then there is only incomplete reimbursement.

The IRS has continued to press its victory in *Mannocchio*, using both the reimbursement rationale and the § 265 rationale. In some instances, the application of *Mannocchio* seems unremarkable.⁴⁴ And the IRS has

removed the deductibility of home mortgage interest payments and real property taxes from the application of § 265 when such payments were tied to military housing allowances. This incomplete response leaves open questions about the applicability of § 265 to other uses of such exempt benefits, including basis in homes.

41. For taxpayers whose deduction would only be as an employee business deduction, available only in computing taxable income (below the line) under § 62, the exclusion may be more beneficial than the deduction. In recent years, such a deduction would not only have not reduced adjusted gross income, but would also have been subject to the limitations of § 67 (that is, the 2% floor), § 68 (the “haircut” of itemized deductions for higher income taxpayers), and the alternative minimum tax.

42. The confusion stems from the fact that the additional reimbursement would be subject to tax as well, calling for round after round of reimbursement. The solution is that the “grossed-up” payment should equal the target payment divided by the term $(1-T)$, where T is the assumed tax rate.

43. Not only would it be very difficult to have the grossing-up occur in the same year as the underlying payment that entitled the receipt of the payment, but the tax rate to be used would have to be each individual taxpayer’s actual marginal tax rate.

44. *E.g.*, *Induni v. Comm’r*, 990 F.2d 53, 57 (2nd Cir. 1993) (holding that mortgage interest deductions were not available when taxpayer had enjoyed exclusion of a living quarters allowance under 5 U.S.C. § 5923(2)). The court viewed the 1986 enactment of § 265(a)(6) as “ratify[ing] the more expansive view of Section 265(a)(1)” that the IRS had espoused in the 1980’s. *Id.* The court appears to have assumed that the interpretation of § 265 by the IRS in Rev. Rul. 83-3, where “the taxpayer has incurred expenses for the purposes for which the tax-exempt income was received” was the standard ratified. *Id.*

Similarly, in *Lapin v. United States*, 655 F. Supp. 1344 (D. Haw. 1987), the court held that the portion of state income tax paid on a cost of living adjustment that was exempt from

shown some restraint in pressing its position; it has ruled that deductions for otherwise deductible expenditures (including home mortgage interest, state taxes, and investment interest) are not limited by its § 265 analysis, simply because *all* of the taxpayer's salary is exempt.⁴⁵ In other situations, however, it has urged its interpretation in contexts in which it is not entirely clear that the net no-benefit result is appropriate.⁴⁶ In still others, the taxpayer has ended up in a worse position for ever having enjoyed the exclusion at all. For instance, in *Stroud v. United States*,⁴⁷ the court upheld the government's position that payments made for breach of terms of the National Health Services Corps Scholarship Program would not be deductible, even though these payments were three times greater than the total of the excluded funds received. While one might find full deductibility inappropriate (perhaps on a tax benefit theory), complete denial seems punitive. While a punitive response might be appropriate, the invocation of § 265 to reach such a conclusion is not.⁴⁸ At the same time, however, the IRS has continued to press the more natural reading of § 265, to deny a deduction for costs invested in ways expected to produce an exempt return. Payments to lawyers, application fees, and other costs of this sort will generally not be deductible when expended in anticipation of excludable receipts. As far as this author is aware, the IRS has

federal income tax but not state income tax under 26 U.S.C. § 912(2) could not be deducted. The position in *Lapin* was consistent with a fairly well-developed body of prior law, established when many more types of compensation income were likely to be exempt. *E.g.*, *Curtis v. Comm'r*, 3 T.C. 648 (1944); *Heffelfinger v. Comm'r*, 5 T.C. 985 (1945); *Marsman v. Comm'r*, 18 T.C. 1 (1952), *aff'd in part and rev'd in part*, 205 F.2d 335 (4th Cir. 1953). Despite these government victories with respect to state income taxes owed on federally-exempt income, there are no cases regarding other types of expenses that might be "associated with" but not "lead to the production" of exempt income. It is difficult to surmise whether this void is the result of the taxpayers not claiming deductions for such expenditures, or whether the government did not challenge them.

The patterns in *Rickard v. Commissioner*, 88 T.C. 188 (1987), (disallowing deductions and investment tax credits for expenses relating to the use of Indian land, the income from which was exempt under the doctrine of *Squire v. Capoman*, 351 U.S. 1 (1956)) and *Arclote Psychiatric Center v. Commissioner*, 76 T.C.M. (CCH) 175 (1998) (disallowing deductions when hospital lost its tax exemption, of payments relating to business conducted when tax exempt) were a bit less clear within the *Mannochio* framework.

45. I.R.S. Priv. Ltr. Rul. 2001-27-041 (July 6, 2001). The IRS also took a less aggressive stance in I.R.S. Chief Couns. Adv. Mem. 2002-46-003 (Aug. 1, 2002) (allowing a taxpayer who receives damages in a judgment requiring that punitive damages be paid to the state, to deduct the entire amount of attorney fees, without allocating a portion to punitive damages paid directly to the state).

46. It has indicated that it would deny a deduction for the use of amounts received by businesses affected by September 11 from private charities, but it has not, to this writer's knowledge, so ruled. *Compare* Letter from Lewis Fernandez, Deputy Associate Chief Counsel, Income Tax Accounting to Richard M. Lipton, Chair, Section of Taxation, A.B.A. (Apr. 15, 2002), ABA Tax Section, <http://www.abanet.org/tax/pubpolicy/2005/050915kat.pdf> (last visited Feb. 26, 2006), *with* rulings discussed below, *infra* notes 55-56 and accompanying text.

47. 906 F. Supp. 990 (D.S.C. 1995), *aff'd on these issues*, 94 F.3d 642 (4th Cir. 1996). The taxpayer in *Stroud* received just under \$80,000 in tuition assistance for medical school, and, within four years after the last assistance was received, owed \$400,000 including interest.

48. The court in *Stroud* acknowledged, but did not decide based upon, denial of deductibility under § 162(f). *Cf.* *Hawronsky v. Comm'r*, 105 T.C. 94 (1995).

never asserted that both approaches would apply to the same fact pattern, although it would appear to be only a matter of time before such a circumstance will present itself.

PART II: THE NEW CHALLENGES

Into this body of administrative practice, Congress, in response to the events of September 11, enacted new § 139 of the Code.⁴⁹

The section originally provided for the exclusion for various types of “disaster relief payments” made to individuals. Some, but not all, of the payments covered by the original terms of § 139 would have likely been entitled to exclusion under the prior administrative practice. All payments referred to in the statute are keyed to the occurrence of a particular disaster, although the disasters covered are of various types and generally require some sort of official designation as such by a state, local, or federal authority. Relief payments made by any payor appear to be covered as long as they represent payment for “reasonable and necessary personal, family, living or funeral expenses” or for “the repair or rehabilitation of a personal residence or repair or replacement of its contents.”⁵⁰ Relief payments made by governmental agencies are excludible so long as they are made “to promote the general welfare.”⁵¹

Conspicuously absent from these requirements are the limitations that historically have applied to payments that are not intended as compensation for specific losses, that is, the requirement that the payments be made in accordance with need. While the fact of the disaster might itself justify a presumption of need in some cases, such a presumption is clearly not appropriate in all cases. Furthermore, many payments aimed at the particular individuals’ needs, including capital expenditures relating to housing, need not be made by government entities.

In its earliest rulings after the enactment of I.R.C. § 139, the IRS made clear that the enactment of the section did not pre-empt the general welfare doctrine, even with respect to payments very similar in nature to those included within the statute. Little else about the effect of the statute and its interaction with the general welfare doctrine, and with other statutory exclusions, was as clear. In Rev. Rul. 2003-12,⁵² the IRS attempted to sort some of this out; with respect to payments made to reimburse flood victims for medical, housing, and transportation expenses resulting from the flood, it concluded that payments from governments could not be excluded as gifts, but could be excluded both under § 139 and the general welfare doctrine.⁵³ Payments made by charities, on the other hand, could be excluded as gifts, and not under the general welfare

49. I.R.C. § 139 (2004).

50. *Id.* § (b)(1)-(2).

51. *Id.* § (b)(4).

52. Rev. Rul. 2003-12, 2003-3 I.R.B. 283 (stating that § 139 “codifies but does not support” the administrative practice).

53. *Id.*

doctrine, without considering whether they could be excluded under § 139. Finally, payments from employers could be excluded only under § 139, and not under either the general welfare doctrine or as gifts.⁵⁴ Although the ruling went to some length to specify exactly which doctrines might apply, depending upon the identity of the payor, the ruling is less than clear about how the consequences might vary depending upon which doctrine was applicable. One can only speculate that the IRS was aware of the possible differences in the ancillary consequences of the exclusion under the three provisions, but unwilling to announce its conclusions.

The scope of § 139 soon became a matter of considerable political controversy.⁵⁵ In recent years, disaster relief and other public assistance programs have become less concerned with emergency aid to victims and more targeted toward prevention and investment in economic infrastructure. Such programs are, for example, designed to provide funds to allow businesses and homeowners to flood-proof their buildings (for instance, by elevating foundations) or even to relocate, to mitigate the damage of a predictable future flood.⁵⁶ With the shift from disaster relief (and the presumption of need likely to accompany disaster relief) to disaster mitigation (where no such presumption seems appropriate, at least with respect to the particular grantee, who may be a significant economic presence in a community rather than a victim likely to be rendered destitute by a disaster), the traditional general welfare doctrine is less likely to apply. But in the popular mind, many such programs are direct substi-

54. *Id.*

55. There are other issues regarding the scope of § 139 that remain unresolved. Section 139(a) provides an exclusion only to "individuals," and, although most of the payments described in the statute related to the personal needs of the taxpayer, § 139(b)(4) provides an exclusion for any payment made by government instrumentalities "to promote the general welfare." Some early interpretations suggested that payments to businesses could never be seen as promoting "general welfare." See Letter from Charles O. Rossotti, Commissioner, to Carolyn Maloney, Representative, New York (Nov. 6, 2002), available at <http://maloney.house.gov/documents/olddocs/Sept11/110602IRSResponse.pdf>. This position was at first only suggested in the rulings published by the IRS. Thus § 139 could provide a basis for excluding payments to individuals with respect to the affect of damage to their businesses, especially if operated as sole proprietorships, but perhaps even with respect to their ownership interests in entities. The IRS rejected this possibility, however, in Rev. Rul. 2005-46, 2005-30 I.R.B. 120. See also I.R.S. Notice 2003-18, 2003-14 I.R.B. 1.

Subsections 139(a) and (b) clearly provide no basis for exclusion of amounts paid directly to entities. For corporations, exclusion with the denial of basis is afforded by § 118. There appears to be no similar authority for entities like partnerships and LLCs to which § 118 does not apply. See generally authorities cited *supra* note 20.

Legislation is still pending that would provide in an uncodified provision an exclusion for all September 11 payments without regard to the nature of the payment. See, e.g., H.R. 2196, 106th Cong. (1st Sess. 2005) (introduced by Rep. Maloney and others). Those in Congress who originally sought to provide grounds for exclusion of all September 11 disaster payments clearly understood that the benefit of an exclusion would be threatened by the denial of a deduction. See Letter from Carolyn Maloney, Representative, New York, to Robert Wentzel, Acting Commissioner (Dec. 13, 2002), available at <http://www-maloney.house.gov/documents/olddocs/Sept11/040703HasterFrist.pdf>. The fact that not all of these original supporters remain suggests that the benefit of the exclusion given the cost of the denial of basis is not worth the political capital that might be expended in obtaining the exclusion.

56. 42 U.S.C. §§ 4001, 5121(b)(4) (West 2006).

tutes for victim relief: in effect, providing current benefits to potential future victims, with the goal of limiting the damages experienced by these specific victims and minimizing the overall economic impact of future disasters.

In examining such programs the IRS concluded, consistent with its prior positions relating both to relief targeted at specific property losses and to general economic subsidies, that such payments should not be excludible from the recipient's income under the general welfare doctrine.⁵⁷ Unlike many such payments in the past, such payments made now are often made directly to the private property owner who then engages in the work, and not to the local government which then contracts for work to be done. The receipts are therefore much more likely to be properly considered to be within the total control of the recipient. These payments, furthermore, are far more likely to have been made in amounts significant enough to trigger a substantial tax liability, and yet not to involve circumstances in which the upfront tax liability would soon be mitigated by cost recovery deductions.

The net result of this position was seen, however, as a catch-twenty-two for recipients: recipients accepting funds needed to spend them as designated by the program (even if they would not have spent as much of their own funds and even if the immediate increase in value of their property did not justify the expenditure), but could incur a tax liability of up to forty percent of the amount received. Indeed, the resulting tax liability could be greater than the individual taxpayer's perception of the value of the funded project. And, given that most such federal programs required matches from local governments, the ruling in effect required a local government to make a contribution (determined according to the recipient's tax rate) to the federal government.

The political reaction to this announced position was relatively swift: extension of § 139 to cover disaster mitigation was included in the President's budget proposals announced in the fall of 2004 and was enacted with the added flair of a Presidential signature on April 15, 2005.⁵⁸ The new legislation added exclusions for "qualified disaster mitigation payments," defined only to include payments made under specific existing federal programs.⁵⁹ It also contained its own limited denial of double benefit provision: "no increase in the basis . . . of any property shall result from any amount excluded under this subsection with respect to such property."⁶⁰ This language, it would appear, attempts to provide the same result available to those receiving cost sharing payments under § 126.

This new subsection also specifically denies exclusion to "any amount

57. I.R.C. § 139(b).

58. I.R.C. § 139(g), added by the Proper Tax Treatment of Certain Disaster Mitigation Payments, Pub. L. No. 109-7 § (1)(a), 119 Stat. 21, 21 (2005).

59. *Id.* § (g)(2).

60. *Id.* § (g)(3).

received for the sale or disposition of any property.”⁶¹ There is some irony to this limitation, since some of the more extreme cases publicized in the campaign for expanding § 139 involved payments to facilitate relocation, which frequently take the form of local government acquisition of properties located in hazard-prone areas.⁶² More likely than not, however, such taxpayers actually needed little relief. For taxpayers moved from residences, the provisions of § 121 afford an exclusion for any gain on the sale to the government;⁶³ for taxpayers moved from businesses, and to the extent the benefits of § 121 are not available, § 1033 should operate in the ordinary way.

But the 2005 legislation was not limited to providing this new exclusion. The price paid for the extension of the exclusion to mitigation payments was the clarification of the extent to which all amounts excluded under § 139 were subject to a “denial of double benefit” rule.⁶⁴ New section 139(h) provides that “no deduction or credit shall be allowed (to the person for whose benefit [the payment is made]) for, or by reason of, any expenditure to the extent of the amount excluded . . . with respect to such expenditure.”⁶⁵

The drafting of this more extensive denial of double benefits provision leaves much to be desired. It refers only to “deductions . . . for, or by reason of any expenditure of the amount excluded.”⁶⁶ Is this a reference only to deductions, or is it a limitation on all use of basis? In recent years, the IRS has unhesitatingly taken the position that similar references to “deduction” in statutory language should be interpreted to include both current deductions and basis.⁶⁷ Such an approach would seem appropriate here, except that the more limited denial-of-double benefit provision subsection 139(g)(3) relating to disaster mitigation payments specifically refers only to basis. How should the two be read together—as if subsection 139(g)(3) refers only to basis in the narrow sense and subsection 139(h) refers only to deductions in the narrow sense, or as if the two invoke the same general principle, and therefore subsection 139(g)(3) is redundant? Or are there other ways of reconciling the provisions, so that each can be given some independent meaning—for instance, that § 139(h) refers only to deductions, and not to basis to be used

61. *Id.* § (g)(2).

62. See Jeff Harington, *IRS to Tax Federal Hurricane Grants*, ST. PETERSBURG TIMES ONLINE, Oct. 27, 2004, available at www.sptimes.com/2004/10/27/Business/IRS_tax_federal_hu.shtml; Press Release, United States Senate, Bond Bill to Stop IRS “Disaster Tax” Passes Senate, Legislation Will Protect Emergency Funds for Flood, Tornado and Hurricane Victims (Apr. 14, 2005), available at <http://www.bond.senate.gov/astwork/recordtopic.cfm?id=236374>.

63. Section 121 generally allows the exclusion of up to \$500,000 in gain to married taxpayers who have lived in the property sold for at least two years.

64. I.R.C. § 139(h).

65. *Id.*

66. *Id.*

67. See, e.g., Rev. Rul. 95-74, 1995-2 C.B. 36; Treas. Reg. § 1.461-1(a) (1967).

only in calculating gain on sale?⁶⁸

Regardless of how § 139(h) is interpreted, the interaction of § 139 and § 265(a) will present further interpretive problems. Section 139(h) is at least in part duplicative of the interpretation of § 265(a) that would deny basis for the use of excluded funds. Could the application of § 265(a) that denies deductibility for expenses intended to produce an excluded return also be applied to deny a deduction for the costs of obtaining disaster relief and disaster mitigation funds?

PART III: ESTABLISHING PRIORITIES IN TAX-BASE DESIGN

Despite the importance that accurately gauging each taxpayer's income has played in the historical development of the income tax base, other criteria have also played important roles. Under the income tax, only income, or new value, is to be taxed. The income tax base generally includes a value based on the exchange of that value by a taxpayer in the market. The value received in the exchange, less the costs incurred in creating that value, is subject to tax. Each taxpayer is taxed only on her discrete addition of value, as measured by the value she receives, reduced by any value she has used up in creating the new value. Thus, under an income tax, those who create and transfer value prior to the transfer to the ultimate consumer must pay tax to the extent of the new value actually created, either by them or by others sharing with them because of a financial investment. But they are taxed as soon as the value they create is exchanged, whether or not the receipt is consumed immediately.⁶⁹

In sum, the income tax seeks to tax new value in the hands of those who create it, when it is created, even if that time is long before the time the value is consumed. (For simplicity, those who share in value creation because they make their capital available will be referred to as value creators. This simplification emphasizes that the primary concern is with the time at which tax is properly imposed under the income tax.) The income tax, as least as currently implemented, is ambivalent about whether this creator of value is the actual consumer of the value. On the one hand, the treatment of gifts suggests that the normative emphasis is on the creator of the value. Once the value has been taxed upon creation, it can be

68. Other provisions added by Act of Sept. 25, 2005, Pub. L. No. 109-73, 119 Stat. 2016, also contained their own denial of double benefit provisions: § 304, providing an exclusion for mileage reimbursements for the use of automobiles for charity volunteers, provides that no "deduction or credit shall be allowed under any other provision of such Code with respect to the expenses excludable." *Id.* § 304, 119 Stat. at 2024-25. Section 401 provides that no income should be recognized on the discharge of nonbusiness bad debt of individuals in certain hurricane affected areas, but in a somewhat cryptic provision, includes a subsection (d) entitled "Denial of double benefits" that merely states that "the amount excluded from gross income . . . shall be treated in the same manner as an amount excluded under section 108(a)." *Id.* § 401, 119 Stat. at 2026.

69. If the receipt is reinvested, either directly in a project in which the taxpayer creates value or through financing of a project of another taxpayer, the later receipts, less costs, will also be included in the tax base. Most discussions of the tax base choice focus on these financial receipts, because they are taxed only in the income tax base, not in many of the other competing tax bases.

transferred to others for consumption without reduction in the donor/creator's tax base or increase in the donee/consumer's tax base.⁷⁰ On the other hand, many exceptions appear to allow reduction in the tax base when the creator clearly will not consume values previously taxed. The deduction for state and local taxes, the charitable deduction, and the deduction for casualty losses all can be seen as exceptions to the general rule that it is value creation, not value consumption, that determines income tax liability.

This view of the income tax may not be as familiar to some readers as the traditional emphasis on the consumption values available to each taxpayer asserted at the outset of this article. Some insist that difficult questions under the income tax should be analyzed in terms of the change in wealth of the recipient, without regard to the source of that change in wealth. Indeed, that appears to be the holding of the Supreme Court in *Commissioner v. Glenshaw Glass*.⁷¹ The principal extension of the tax base beyond the base derived by focusing upon incremental value is in the area of windfalls receipts that are not attributable to the efforts of the recipients.

It is not clear, however, how far the result in *Glenshaw Glass* actually extends beyond the reach of an incremental value approach to the income tax. Some windfalls, like finding a pearl in an oyster, are simply "found" value, included in the tax base as if the taxpayer had created the entire value. Other values included under the *Glenshaw Glass* rubric, but not incremental value attributable to the recipient, are likely to have been deducted from the tax base of the creator to which they are attributable. That creator has treated the value either as lost or as a factor in the creation of new value, in a process in which the taxpayer receiving the windfall played only a minor role. Those values that remain in the tax base, like the treble damages in *Glenshaw Glass* itself, remain because of overriding policy concerns regarding the implementation of the regulatory schemes which compel the transfers in question.

Under this view, an exclusion for transfer payments simply reflects that the recipient is neither the creator of value, nor someone entitled to share with the creator because of a financial investment in the value's creation. The receipt, like the more frequently encountered gift excluded under § 102, is not the appropriate moment for taxation, since there has been no new value created in which the government is entitled to a share. That moment, under the view of the income tax presented here, was on the creation of the value by the transferor or some predecessor of the transferor.

Whether the value was in fact captured upon its creation at the hands of some predecessor transferor may be difficult to determine, and may

70. The inclusion of any appreciation attributable to the time before the transfer in the donee's tax base, is merely an accident of the realization rules. See *Taft v. Bowers*, 278 U.S. 470, 482, 484 (1929).

71. 348 U.S. 426, 431 (1955).

not therefore be suitable as a criterion for determining whether an amount ought to be excluded. For instance, the federal income taxes of individual taxpayers have not been deducted from their tax bases; payments from such receipts would properly be considered as payments of already-taxed values. State income taxes may have been deducted, but most state sales taxes will not. Under such circumstances, it seems silly to attempt to develop a coherent set of rules for excluding transfer payments based on whether the amount actually represents an already-taxed value. Nevertheless, the fact that a substantial amount of such transfers have in fact already been subject to tax suggests that, in terms of this criterion for defining the income tax base, it is impossible to determine whether the greater error might occur in the inclusion or the exclusion of such amounts. Indeed, at the limit, an inclusion in the income tax base by the amount of transfer payments made would overstate the sum of newly created values by more than the tax rate to which the payments were subject.⁷²

The proffered justifications for exclusions of transfer payments have not, however, generally relied upon this view of the income tax. To the extent such justifications have been offered, they have relied upon a sense that in a progressive income tax, exclusions for amounts that are received based upon the need status of the recipient are appropriate as both normative and practical matters, since inclusion is not likely to result in taxable income. Additionally, it may appear unseemly for the federal government to claim a share of all transfer payments, especially when such a claim would simply mean that the budget for the program would have to be grossed up to account for the tax in order for the goals of the transfer payment system to be met.

This approach to the general welfare doctrine itself would go a long way in sorting out the ways in which ancillary doctrines should be invoked to avoid inappropriate "double benefits." If the transfer payment truly is a transfer payment, a payment in a context in which the recipient could be seen neither as participating in the creation of any new value nor as being reimbursed for a recent loss of after-tax value, the presumption should be that the recipient will be able to account for her use of the value without regard for its source. This approach would allow both recipients of government payments excluded under the general welfare doctrine and recipients of unrestricted private charity the same after-tax benefit from their receipts. If, on the other hand, the exclusion is provided merely to prevent a grossing-up problem in ascertaining the appropriate amount of the receipt, then the resulting expenditures should not produce a tax benefit.

Should these conclusions be articulated in a statute or left within the province of the IRS? The answer to this question lies in part in one's

72. Each dollar of transfer payment would create fifteen cents of tax receipts, which would in theory enable another fifteen cents of transfer payments, which would result in another seventy-five cents of tax, and so forth.

faith in the competence of Congress.⁷³ A plausible solution might be to clarify that the IRS has the authority to grant nonstatutory exclusions along the lines of the general welfare doctrine and the authority to announce ancillary rules for implementing those exclusions. But if basis will be denied for the use of the receipt under the ancillary rule, such a position can only be enforced prospectively.

PART IV: CONCLUSION

Perhaps it would be better to consolidate all transfer payments programs and coordinate their treatment coherently within the federal tax system. That does not, however, seem likely in the near future. State and local government units are likely to continue to design and administer their own programs. Federal programs are likely to continue to be designed in relatively haphazard ways, depending upon the coincidence of

73. One can easily doubt the competence of Congress to draft effective and consistent provisions limiting double deductions if one examines the inconsistencies in some of the provisions designed at limiting double benefits.

Denying other benefit where credit provided:

1. Adoption credit: two separate denials, one for items that are deductible, and one "to the extent that funds for such expense are received under any Federal, State, or local program." I.R.C. § 23(b)(3)(A), (B) (West 2006).
2. Denying leaving credit for any amount for which a deduction is allowed. *Id.* § 25A(g)(5).
3. Employer credit for employer payment of social security with respect to tips. *Id.* § 45B(c). "No deduction shall be allowed under this chapter for any amount taken into account in determining the credit under this section." *Id.*
4. Denial of deduction or basis for amount taken as credit for disabled access expenditures (credit is for fifty percent of expenditure). *Id.* § 44(d)(7).
5. Credit for investment in employer-provided childcare facilities (percentage of expenditures, with cap), with basis reduced by amount of credit. *Id.* § 45F(f).
6. Alternative motor vehicle credit denying other deduction or credit, to the extent credit is taken. *Id.* § 30B(h)(5) (seemingly reducing deductions by amount of credit, which incompletely and irrationally affects overall benefits).

Denying some but not all double benefit:

1. Section 29(g)(2)(C) contains a "denial of double benefit" that prevents claiming credit for a facility producing nonconventional fuels, if a credit for the same facility was claimed in a prior year, apparently not limiting the credit (which is not computed by reference to any actual expenditure) by any benefit from cost recovery or deduction. *Id.* § 29(g)(2)(c).
2. Denying inclusion of single cost in two separate measures of research credit, but leaving cost unaffected by claim of credit. *Id.* § 41(f)(6)(D).

No "double benefit for exclusions":

1. Energy conservation subsidies provided to customers by public utilities. . . Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, any expenditure to the extent of the amount excluded under subsection (a) for any subsidy which was provided with respect to such expenditure. The adjusted basis of any property shall be reduced by the amount excluded under subsection (a) which was provided with respect to such property. *Id.* § 136(b).

No deduction for exclusion:

1. No regulations prescribed under this section shall permit the utilization of any deduction (or other tax benefit) if such amount was in effect reimbursed by nontaxable Federal financial assistance. *Id.* § 597(b)(3).

beneficiaries' needs and the coalitions that can be formed to meet those needs. Given this reality, there seems to be a clear need to rationalize not only the grounds for granting exclusions for transfer payments and the consequences thereof, but also the appropriate role of the IRS and Congress in the rationalization process.

