



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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Dear _____ :

This letter responds to your inquiry to Senator Pete Domenici about the _____ tax rebate. Senator Domenici asked us to respond to you directly.

In November 2005, the State of _____ (State) provided payments from surplus state funds to State residents based on their adjusted gross income and the total number of exemptions shown on their 2004 State personal income tax returns. Individuals were not eligible to receive a payment if (1) they were a dependent of another individual during the 2004 tax year, (2) they were not a resident of State on the last day of the 2004 tax year, or (3) they were an inmate of a public institution for more than six months during the 2004 tax year.¹ You ask why the recipients must report these State payments on their federal income tax return as gross income.

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived unless another provision of law specifically excludes the payment from gross income.² This means that the State payments are taxable to the recipients unless the payments qualify under one of the general exclusions from gross income. Three types of payments are excludable from gross income: (1) refunds of state income taxes paid for which a taxpayer does not receive a federal tax benefit, (2) gifts, and (3) general welfare payments.

¹ See Section 3, H.B. No. 10 (2005 _____ Session Laws).

² See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431, *reh'g denied*, 349 U.S. 925 (1955) (holding gross income encompasses any item representing "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

The State payments are not refunds of state taxes. It is our understanding that the State payments are not related to the amount of state income tax, or other tax, that a recipient previously paid. The amount of the rebate is not reflected in a taxpayer's income tax account. Under the program, a resident can receive a rebate in excess of any state income tax paid. In other words, the total of the tax payments made by a resident of State in 2005 was not reduced by the rebate he or she received. Thus, that resident was enriched by the State payment and therefore is taxable on the payment.

The State payments do not qualify for exclusion from income as gifts under section 102 of the Code. To qualify as a nontaxable gift, a payment must be made from a "detached and disinterested generosity ... out of affection, respect, admiration, charity, or like impulses."³ Generally, governmental payments have been treated as gifts only if the payments have been made to a limited group of individuals based on merit or service, such as a state's payments to war veterans.⁴ Neither H.B. No. 10 nor its legislative background indicates that the State payments are made to a limited class out of affection, generosity, charity, or like impulses.

The State payments also do not qualify for exclusion under the administrative exclusion for general welfare payments. To qualify as general welfare payments, the payments must (1) be made from a governmental fund, (2) be for the promotion of the general welfare (i.e., generally based on individual or family needs), and (3) not represent compensation for services. The State payments do not satisfy the second requirement, i.e., to help needy individuals pay for expenses such as housing, education, and basic sustenance. Therefore, the State payments are not excludable as general welfare payments.

Because the State payments do not qualify for any of the possible exclusions from gross income, recipients must include the payments in gross income for federal income tax purposes.

Many have expressed concerns that taxpayers would be required to file the longer Form 1040 rather than the short Forms 1040A or 1040EZ in order to report the State payments because Forms 1040A and 1040EZ do not have specific lines for these payments. As you may already know, the Internal Revenue Service addressed this concern and has allowed taxpayers to report the State payments on line 13 of Form

³ *Duberstein v. Commissioner*, 363 U.S. 278, 285-86 (1960) (quoting *Commissioner v. Lobue*, 351 U.S. 243, 246 (1956) and *Robertson v. Commissioner*, 343 U.S. 711, 714 (1952)).

⁴ See Rev. Rul. 68-158, 1968-1 C.B. 47 (holding state payments to or on behalf of veterans who served in the Armed Forces during war time were not includible in gross income); and *Dewling v. United States*, 101 F. Supp. 892 (Ct. Cl. 1952) (holding payments from the federal government were gifts in recognition of the services rendered for construction of the Panama Canal).

1040A and line 3 of Form 1040EZ. A copy of the IRS news release announcing this position is enclosed.

I hope this information is helpful. If you need further information, please contact _____, Identification Number _____, at (_____) _____.

Sincerely,

George J. Blaine
Deputy Associate Chief Counsel
(Income Tax and Accounting)

Enclosure