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

OFFICE OF
CHIEF COUNSEL

MAY 8 1992

The Honorable Jack Kemp
Secretary of Housing and Urban Development
U.S. Department of Housing
and Urban Development
Washington, D.C. 20410-0001

Dear Secretary Kemp:

This is in response to your December 31, 1991, letter requesting an opinion on the possible tax consequences of the Family Self-Sufficiency (FSS) program.

Specifically, you have inquired whether interest earned on escrow accounts established as part of the FSS program has a tax consequence either to the public housing agencies (PHAs) and Indian housing authorities (IHAs) or to the families that participate in the program. You also ask whether any Forms 1099 will be required.

I. Summary of the facts.

The FSS program was created by section 554 of the National Affordable Housing Act (the Act), which amended title I of the United States Housing Act of 1937 (42 U.S.C. section 1437 *et seq*.) by adding a new section 23. The stated purpose of the FSS program "is to promote the development of local strategies to coordinate the use of public housing and assistance under the certificate and voucher programs under section 8 with public and private resources, to enable eligible families to achieve economic independence and self-sufficiency."

Under the FSS program, residents of public housing (including section 8 housing) or applicants on public housing waiting lists with certain qualifying income levels may opt to join the program. These participating families enter into a contract with the PHA/IHA that spells out the responsibilities of the family, including the conditions or causes of termination from the program. During the period of the contract (generally 5 years), the head of the participating family must seek and maintain suitable employment (as determined by the head of family's skills and education and jobs available within the jurisdiction). The Act requires the PHAs/IHAs to develop support services, such as child care, remedial education, job training and preparation, substance abuse treatment and counseling, homemaking and parenting skills, training in money management, and any other services necessary to assist families in satisfying the contract terms.

As an incentive for a family to enter into a contract with a PHA or an IHA, payments are made to an interest bearing, escrow account (FSS Account). The PHA/IHA will credit the FSS Account with a portion of the rent increase (rent credit) that would otherwise be paid by the family as a result of an increase in family earned income during the term of the contract. However, if the family income rises to 80 percent or more of the area median income, no additional rent credits will be made to the FSS Account. The funds held in escrow are to be invested in HUD-approved investments. Investment income is to be credited periodically, but no less than annually, to each family's FSS Account. (Although the program guidelines contemplate separate accounts for each participating family, it is our understanding that one account will be maintained on behalf of all the families with respect to each PHA/IHA. If the funds in the one account exceed $100,000, another account will be opened to ensure that all funds receive FDIC insurance coverage.)

The FSS program generally is optional with PHAs/IHAs in fiscal years 1991 and 1992. As of October 1, 1992, however, each PHA/IHA, unless exempted by HUD, must operate an FSS program of a required size, subject to the availability under appropriations acts of budget authority for the rental voucher, rental certificate, public and Indian housing programs.

The Act does not address the funding for the FSS Accounts; however, the participating families pay the same amount for housing as is paid by non-participating families. Therefore, the transaction could be viewed as one in which the participating families pay increased rent from which a contribution is made by HUD to the escrow account.

The amount in a participating family's FSS Account in excess of any amount owed to the PHA/IHA is distributed when: (1) the PHA/IHA determines that the participating family has met its obligations under the contract of participation; and (2) the head of the family certifies that, to the best of his or her knowledge and belief, members of the participating family no longer receive any federal, state, local, or other public assistance or housing.

The amount in the FSS Account is forfeited if: (1) the family has failed to meet its obligation under the contract of participation, including failure to meet its responsibilities because the family moved outside the area of jurisdiction of the PHA/IHA; or (2) the family is no longer under a contract of participation and is still receiving any Federal, state, local or other public assistance for housing ten years from the commencement of the contract of participation.

The amounts forfeited by a public or Indian housing or section 8 participant will be treated as program receipts for such program, and the funds will be used in accordance with HUD requirements governing the use of program receipts.

II. Applicable law and conclusions.

A. Tax treatment of the FSS Accounts.

Section 641 of the Internal Revenue Code provides that the tax imposed by section 1(e) applies to the taxable income of any kind of property held in trust.

Section 1.641(a)-0(a) of the Income Tax Regulations provides that Part I of Subchapter J, which contains rules for the taxation of trusts, has no application to any organization that is not classified for tax purposes as a trust under section 301.7701-4(a) of the Regulations on Procedure and Administration.

Section 671 of the Code provides that a grantor or another person shall include in computing the taxable income and credits of the grantor or other person those items of income, deductions, and credits against tax of a trust which are attributable to that portion of the trust of which the grantor or the other person is treated as the owner. Therefore, unless an organization is classified as a trust, the grantor trust rules do not apply.

Section 301.7701-4(a) of the Regulations on Procedure and Administration provides, in part, that an arrangement will generally be treated as a trust under the Code if it can be shown that the purpose of the arrangement is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility.

Funds held by the PHAs/IHAs in the FSS Accounts may be invested only in HUD-approved investments. The PHAs/IHAs are required by HUD to credit investment income periodically, but no less than annually, to each participating family's FSS Account. Escrow funds may only be disbursed by the PHAs/IHAs when participating families have completed the obligations to which they agreed in their Contracts of Participation. The duties and authority of the PHAs/IHAs to manage and administer the FSS Accounts are limited and the PHAs/IHAs do not have broad discretionary powers.

Therefore, an escrow arrangement of the kind described in the program guidelines will not be considered a trust under section 641(a) of the Code and section 301.7701-4(a) of the regulations and the PHAs/IHAs are not required to report the interest earned in the FSS Accounts as income subject to taxation under section 641(a) of the Code. Because the FSS Accounts are not trusts, the accounts are not grantor trusts.

However, section 468B(g) of the Code states that "[n]othing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise." Section 468B(g) applies to funds established on or after August 16, 1986.

On February 14, 1992, the Service issued proposed regulations under section 468B(g) of the Code. These proposed regulations, however, do not address escrow accounts of a type similar to the FSS Accounts. Therefore, we cannot provide a definitive answer at this time as to whether the FSS Accounts may be subject to potential liability under section 468B(g) of the Code.

B. <u>Income Tax Consequences of the FSS Account to the FSS Family</u>.

Under section 61 of the Code, gross income means all income from whatever source derived including compensation for services, fringe benefits, interest, and similar items.

Welfare benefits are not included in a taxpayer's gross income. The Service first addressed the question of excluding welfare benefits in I.T. 3230, 1938-2 C.B. 136, holding that unemployment compensation was not included in the recipient's gross income. Since 1938, the Service has examined various programs to determine if payments to participants are welfare benefits. When considering whether a program's disbursements fall within the welfare benefits exclusion, four factors must be examined: (1) the source of the funds for the program; (2) the circumstances of the beneficiaries of the program; (3) whether the payments are compensation for services; and (4) the intent of Congress in establishing the program.

First, to qualify as a welfare benefit, the disbursements generally must come from a local, a state, or the federal government. Under the FSS program, HUD funds the escrow accounts, based upon increases in the participating family's earned income. Thus, the FSS program meets the funding criteria.

Second, to qualify as a welfare benefit, the disbursements must be means or needs tested. For example, benefit payments under the Alaska Longevity Bonus Act to persons continuously residing in Alaska for 25 years and reaching the age of 65 were included in the recipients' gross income because the payments were not needs based. See Rev. Rul. 76-131, 1976-1 C.B. 16. Under the FSS program, participating families must be either residents of public housing or applicants for that housing. Eligibility for public housing is needs based upon strict income formulas. Thus, the FSS program meets the needs or means test criteria.

Third, to qualify as a welfare benefit, the recipient cannot be compensated for services. For example, if a recipient enrolls in a "workfare" type program and benefits are based upon the number of hours the recipient works, the recipient must include those benefits in gross income. Under the FSS program, participating families receive the benefits when they satisfy the terms of their contracts with the PHA or the IHA. Although the contract will require the head of that family to seek and maintain employment, the ultimate benefit amount is not based upon the number of hours worked and employment is not the sole requirement of the contract. Historically, the Service has excluded from recipient's gross income stipends received while in job training programs. See Rev. Rul. 63-136, 1963-2 C.B. 19 (weekly payments to participants in job training program not included in gross income); Rev. Rul. 72-340, 1972-2 C.B. 31 (stipends to probationers enrolled in job training program not included in gross income). Thus, the FSS program benefits should not be considered compensation for services.

Last, to qualify as a welfare benefit, Congress must intend for the disbursement to be a welfare benefit. The Service's determination that Congress intended to consider a program for the public welfare does not require an express statement by Congress. The Act states that the purpose of the program is to "enable eligible families to achieve economic independence and self-sufficiency." This goal is similar to other public welfare programs that the Service has examined in the past. See Rev. Rul. 63-136, (payments to aid recipients in their efforts to acquire new skills, enabling them to obtain better employment opportunities). See also Rev. Rul. 72-340, (payments to aid individuals to acquire training for new skills); Rev. Rul. 74-205, 1974-1 C.B. 20 (payments to further implement goal of providing a decent and suitable home for every American). Thus, congressional intent strongly indicates that the program is for the public welfare.

If the PHAs and the IHAs do not establish a separate account for each participant (i.e., assuming the participants have no present interest in the funds held in escrow), and if the benefits are needs based, the disbursements (including the interest) are welfare benefits and are not includible in the gross income of the recipients.

C. Information Reporting.

Under section 6041 of the Code, payors of fixed or determinable gains, profits, and income aggregating $600 or more are required to file Forms 1099 with the Internal Revenue Service.

Distributions that are not includible in the gross income of the FSS program participants, as discussed above, are not required to be reported on Forms 1099. This conclusion also applies to the accumulated interest in the FSS Accounts unless a portion of the distribution is specifically allocated to interest.

The above opinion is based on the program guidelines and may not apply to any PHA/IHA that establishes an FSS Account that varies from those guidelines. Also, regulations promulgated under section 468B(g) of the Code may affect the current taxation of the interest earned on the FSS Accounts as well as the taxation of any portion of the distributions designated as interest.

We hope this information is helpful in providing guidance both to the PHAs/IHAs and to the FSS families. If any additional assistance or clarification is needed, please contact Michael Montemurro (566-6302) or John McGreevy (535-9365).

Very truly yours,

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