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IN THIS ISSUE

Arrears Forgiven Pursuant to an Approved Arrearage Management Programs (AMP) Fit into Well-Accepted Exceptions to Treating Cancelled Debt as Income for Federal Tax Purposes.

NOTE TO READERS

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Forgiven Arrears are Not Taxable as Gross Income under the Federal Internal Revenue Code.

The forgiveness of arrears by public utilities raises the issue of the extent to which, if at all, that foregone debt is taxable by the Federal government. If it is, not only would there be an obligation on the part of customers receiving the forgiveness to pay the tax, but there would also be an obligation on the part of the utilities to provide year-end forms both to the customer and to the Internal Revenue Service reporting such income.

Generally, the extent to which a household obtains a discharge of debt is includible in the calculation of gross income for that household. Section 61(a) of the Internal Revenue Code controls.[1] Section 61(a)(1) states that, except as otherwise provided, gross income means all income from whatever source derived. Moreover, Section 61(a)(12) explicitly states that the amount of a discharged debt is to be included in the calculation of gross income.

In sum, when a solvent debtor has a fixed obligation reduced or cancelled, the amount of the reduction or cancellation constitutes income for tax purposes. Unless the gain is excluded from income because of a statutory or judicial exemption to this general rule, the amount of the debt that is cancelled is income in the year the debt is cancelled. The issue, therefore, is whether a utility arrearage forgiveness program results in taxable income to the program participant as per

[1] 26 U.S.C. sec. 61(a) (2023).

Section 61(a)(1), or whether such forgiveness falls within some accepted exclusion.

The 2023 Baltimore Letter Opinion

On February 24, 2023, the U.S. Department of the Treasury issued a Letter Opinion to U.S. Senator Chris Van Hollen on a closely-related question. Senator Van Hollen had inquired about Baltimore City's Water for All Program. In his request for guidance from the IRS, Senator Van Hollen explained that the Baltimore program was "designed to create more equitable access to water assistance for low-income Baltimore City water and wastewater customers." He explained further that the program involves "customers [who] are individuals with household income of less than 200% of the Federal Poverty Level (FPL). The program is funded by Baltimore City's water revenues." Senator Hollen noted:

> Individuals who own and occupy their residence and pay their water directly to the utility have their discount applied as a credit on their water bill. Tenants who are billed by the owner of their residence for their share of the water bill receive their discount by check.

Senator Hollen posed the following question (along with two other closely related ones): "Is the amount of the discount that low-income tenants receive under the Water-for-All Discount Program considered taxable income?"

The Department of the Treasury responded that:

> The discounts that tenants receive under the Water-for-All Discount Program are made from Baltimore City funds, are based on individual or family need, and are not compensation for services. Thus, the amount of the discount is excludable from the recipient's gross income under the general welfare exclusion. The general welfare exclusion applies regardless of whether the discount is funded through ARPA (federal government funds) or Baltimore City (local government funds).

The Treasury explained:

> Under section 61 of the Internal Revenue Code (Code), gross income includes all income received from whatever source derived, unless an exclusion applies. The Internal Revenue Service (IRS) has consistently concluded that payments under legislatively provided social benefit programs for the promotion of general welfare are not includible in an individual's gross income (the general welfare exclusion). To qualify under the general welfare exclusion, a program must: (1) be made from a governmental fund, (2) be for the promotion of the general welfare (that is, based on individual or family need), and (3) not represent compensation for services."

The 2023 Advisory Letter is appended to this newsletter.

The Rhode Island Counterpart

The 2023 letter opinion was closely aligned with a 1991 IRS ruling, appended as Attachment B, which held that arrears forgiven by a public utility company in conjunction with benefits delivered through the Low-Income Home Energy assistance Program (LIHEAP) are *not* gross income for federal income tax purposes.

The July 19, 1991 IRS ruling was directed to the arrearage forgiveness component of Rhode Island's Percentage of Income Payment Plan (PIPP). In addition to the income-based payments toward current bills, the IRS found, "to encourage participants to remain in the program, and thereby to maintain uninterrupted energy service, the program also provides that an arrearage owed by a participant to the utility company prior to the participant's enrollment in the program is forgiven on a pro rata basis over a 36-month period."

The IRS cited the LIHEAP statute in its Ruling, holding that "the act specifically states that home energy assistance payments or allowances made pursuant to the Act to or for eligible households are not taxable income to the household." [2] The Ruling continued on to note that Rhode Island "has determined that the forgiveness of arrearages is vital to the program's overall success, and has enacted legislation specifically authorizing the utility companies to forgive the arrears."

Accordingly, the IRS concluded, ". . .neither the payments made by [Rhode Island] to the utility company nor the forgiveness of arrearages is includible in your gross income."

The Applicability of General Federal Tax Law.

The decisions made regarding Baltimore and Rhode Island are consistent with prior decisions of the IRS, including decisions regarding the taxability of utility-provided energy assistance. Most directly on point, for example, is IRS Revenue Ruling 78-170. In this Revenue Ruling, the IRS held that payments made, either directly or indirectly, to income-eligible households for the purpose of reducing the cost of winter energy consumption "are in the nature of relief payments made for the promotion of the general welfare" and are thus not includible in gross income.[3]

An "indirect payment" in this instance would include discounts granted by energy vendors and reimbursed through state tax credits. Thus, while the government benefit is not directly to the energy consumer, it is to benefit that consumer and is an "indirect payment" to that customer. Any arrearage forgiveness program that is part of a social welfare program whereby the utility grants the initial forgiveness and the state reimburses the utility would thus seem to fall within this "indirect payment" exemption.

With a utility program, the "reimbursement" would include cost recovery to the utility through rates approved through a regulatory process. In this instance, the forgiveness is not being provided by the utility, but instead is being funded through a state government-approved cost reimbursement process.

Arrearage forgiveness provisions adopted pursuant to a state (or local) commission mandate or approval would appear to fall within this same *genre* of public welfare programs. Aside from Revenue ruling 78-170 (appended as Attachment C), the Revenue Rulings finding that no taxable income is involved include the following similarities:

1. **Need based**: The programs are "need-based." While LIHEAP eligibility, and thus eligibility for arrearage forgiveness, is based on a percentage of Federal Poverty Level, virtually every utility-based program is also directed exclusively to income-qualified households.

2. **Essentials of life**: As LIHEAP did with energy, and state and local utility regulators (or administrators) have done with utility programs, a utility arrearage forgiveness program (and the rate program

[2] 42 U.S.C. sec. 8624(f)(1).

[3] Citing, Revenue Ruling 74-153 and Revenue Ruling 74-74.

> of which it is generally an essential component) is designed to ensure the continuing availability of home energy, found to be an essential of life in today's modern society.

It can be concluded that an arrearage forgiveness program is one component of a "social benefit program for the promotion of the general welfare." Accordingly, the discharge of debt thereunder should not be construed as gross income.

Ambiguities that Need to be Addressed.

The conclusion reached above that utility-based arrearage forgiveness does not represent taxable income is not unqualified. The relevant Revenue Rulings, for example, refer to "legislatively-provided social benefit programs."[4] If the forgiveness is paid in whole or part through the distribution of LIHEAP benefits, the LIHEAP benefits are clearly available pursuant to a legislatively-provided welfare program. Arrearage forgiveness provisions, however, can be part of a more specific package of rate benefits. In turn, rate programs, while approved by state regulators (or local administrators) may, but need not, be part of a legislatively-provided program.[5]

[4] See, e.g., Revenue Ruling 76-373, Revenue Ruling 76-395 (emphasis added).

[5] It could, however, be easily argued either that the actions of a state public utility commission operating pursuant to state law are actions that are "part of a legislatively provided program." In the alternative, it has commonly been held by the courts that utility ratemaking is "legislative" in nature. Under such a holding, the argument could legitimately be made that rate affordability programs are also part of a legislatively-provided program.

Utility Programs as Programs Using Public Funds

A second potential problem lies in the fact that an arrearage forgiveness program may arguably not be financed with "public funds." Many of the programs addressed by the IRS made payments in pursuit of the general welfare from a government "general welfare fund."[6]

Revenue Ruling 82-106, which addresses relocation assistance benefits to be paid to tenants by landlords under a municipal ordinance, perhaps poses the greatest obstacle.

In Revenue Ruling 82-106, the local city council enacted an ordinance requiring landlords to provide relocation assistance to tenants who were to be evicted from their units because of a conversion of those units to condominiums or cooperatives. The ordinance was enacted "because of a critical shortage of rental housing in [the] city."

The payments in this local tenant relocation situation were found to be "distinguishable from the replacement housing and relocation payments." In the latter instances, an "agency of the federal government makes the payments to qualified recipients. Here the landlords make the payments to tenants who are to be evicted."

The Revenue Ruling then articulated a principle that may, at first blush, appear to support a conclusion that forgiven arrearages *are* taxable income. The Revenue Ruling said: "Payments made by individuals or other non-governmental entities are not considered payments for the general welfare." The fact that tenant payments were made pursuant to a government-imposed requirement was not found to be determinative in this situation. The landlords, in other words,

[6] See, e.g., Revenue Ruling 74-74, Revenue Ruling 74-153.

were required by ordinance to make the relocation payment. Nevertheless, the fact that the payment itself came from an "individual or other non-governmental entity" was found to be the controlling feature.

This result, however, does not directly conflict with the Ohio energy credit program in Revenue Ruling 78-170 above. In that situation, Ohio private energy vendors were directed to provide, during designated times of the year, a 25-percent reduction on monthly bills for home energy consumption to persons meeting certain income and programmatic guidelines.

The privately granted discount, however, was reimbursed by the state to the energy vendors. Those state expenditures, the Revenue Ruling found, were (as discussed above) simply "indirect payments to qualified individuals" and were "in the nature of relief payments made for the promotion of the general welfare."

Why Revenue Ruling 82-106 is not Really a Problem.

The principle involving "private" payments, as articulated in Ruling 78-170, does not sweep as broadly as it might first appear. That Revenue Ruling continued on to state: "moreover, the payments here in question are *not based on need* and are *not a substitute for payments traditionally made by a governmental entity*." It appears, therefore, that this Revenue Ruling is consistent with the Baltimore and Rhode Island decisions discussed above. Clearly, arrearage forgiveness benefits, even if privately delivered on the front-end, are need-based and, in addition, can be argued to be a "substitute for payments traditionally made by a governmental entity." To conclude that arrearage forgiveness is at least an adjunct to, if not a substitute for, further LIHEAP payments is not a big jump.

Moreover, as indicated above, arrearage forgiveness credits that are granted by the utility, but recovered through a cost-recovery mechanism approved by state (or local) regulators, would seem to be akin to the energy discounts that were granted in Ohio but allowed to be reimbursed by state tax credits. In the arrearage forgiveness context, while the utility may be the mechanism through which forgiveness is granted, that forgiveness is not funded with utility dollars. Remember, for example, that the Baltimore letter ruling found that the tenant payments at issue there were funded with funds collected from ratepayers through the local water utility, not with funds appropriated by the local government. It is not as critical that funds come from the government purse as it is that payments are made pursuant to a government program.

Summary and Conclusions

In summary, there are two IRS decisions, with the February 2023 Baltimore letter opinion being the most recent, that support the conclusion that arrearage forgiveness credits do not constitute taxable income under the federal Internal Revenue Code.

1. If provided in collaboration with LIHEAP, the issue is clear cut. The non-taxability is governed by the federal LIHEAP statute, not by the Internal Revenue Code.[7]

2. Arrearage forgiveness is need-based. Arrearage forgiveness payments are dependent upon a household being income-qualified. Moreover, in many if not most programs, the participant's income must be recertified periodically to

[7] See, Revenue Ruling 76-373.

ensure that the household remains income-qualified.[8]

3. Arrearage forgiveness, whether or not made part of the LIHEAP program at the state level, is integral to the success of LIHEAP and, at a minimum, is in the nature of general welfare.[9]

4. Arrearage forgiveness involves payments "in furtherance of the social welfare objectives of the State."[10]

5. LIHEAP benefits involve "payments traditionally made by a government entity" and, arrearage forgiveness, even if not a "substitute" therefore, is an adjunct thereto, and has been found to be integral to the success of the program of payments made by the government.[11]

Given all of the factors discussed above, on balance, it is reasonable to conclude that an arrearage forgiveness program that is adopted as part of a program either mandated by, or approved by, a regulator, particularly if tied closely to the disbursement of LIHEAP (whether or not a "part" of LIHEAP), does *not* involve gross income arising as a result of the discharge of indebtedness.

Persons interested in more information about the Revenue Rulings cited and discussed in this newsletter can write for more information at:

roger [at] fsconline.com

[8] See, Revenue Ruling 75-271.

[9] See, Revenue Ruling 75-271, Revenue Ruling 76-373.

[10] See, Revenue Ruling 74-153.

[11] See, Revenue Ruling 82-106.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

February 24, 2023

The Honorable Chris Van Hollen
United States Senate
Washington, D.C. 20510

Dear Senator Van Hollen:

Thank you for your October 22, 2022 letter concerning Baltimore City's Water-for-All Discount Program, which was established by the City's Water Accountability and Equity Act. You explained that the program was designed to create more equitable access to water assistance for low-income households in Baltimore City. The program provides an annual discount to low-income Baltimore City water and wastewater utility customers. These customers are individuals with household incomes of less than 200% of the Federal Poverty Level (FPL). Individuals who own and occupy their residence and pay their water bill directly to the utility have their discount applied as a credit on their water bill. Tenants who are billed by the owner of their residence for their share of the water bill receive their discount by check. We understand that the program is funded by Baltimore City's water revenues.

You asked us to address the following questions:

- Is the amount of the discount that low-income tenants receive under the Water-for-All Discount Program considered taxable income?
- If the discount is reimbursed to tenants in the form of a pre-loaded cash card does this change their tax liability?
- Would the taxable status of the discount provided by the program change if it is funded through the American Rescue Plan Act[12] rather than through water revenues?

Under section 61 of the Internal Revenue Code (Code), gross income includes all income received from whatever source derived, unless an exclusion applies. The Internal Revenue Service (IRS) has consistently concluded that payments under legislatively provided social benefit programs for the promotion of general welfare are not includible in an individual's gross income (the general welfare exclusion). To qualify under the general welfare exclusion, a payment must: (1) be made from a governmental fund, (2) be for the promotion of the general welfare (that is, based on individual or family need), and (3) not represent compensation for services.

[12] The American Rescue Plan Act (ARPA) established the Coronavirus State and Local Fiscal Recovery Funds to give eligible state and local governments an infusion of resources to meet COVID-19 pandemic response needs.

The discounts that tenants receive under the Water-for-All Discount Program are made from Baltimore City funds, are based on individual or family need, and are not compensation for services. Thus, the amount of the discount is excludable from the recipient's gross income under the general welfare exclusion. The general welfare exclusion applies regardless of whether the discount is in the form of check or a pre-loaded cash card, and regardless of whether the discount is funded through ARPA (federal government funds) or Baltimore City (local government funds).

I hope this information is helpful.

Sincerely,

Jonathan C. Davidson

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Index No.: 0061.00-00

Person to Contact:

Telephone Number:

Refer Reply to: CC:IT&A:02 - TR-31-4432-89

Date: JUL 19 1991

LEGEND:

X =

"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

Dear

This responds to a request submitted by your authorized representative that an arrearage owed by you and forgiven by a utility company under the circumstances described below is not includible in your gross income.

The State of X has adopted a program to assist low-income individuals in paying their home energy costs. To be eligible to participate in the program an individual must be a resident of X and have a household income of 60 percent or less of the median income of the households in X. Each participant in the program pays a fixed percentage of the participant's income as his or her share of home energy costs. The difference between the participant's monthly energy bill and the participant's monthly payment is paid directly by X to the utility company supplying the energy.

To encourage participants to remain in the program, and thereby to maintain uninterrupted energy service, the program also provides that an arrearage owed by a participant to the utility company prior to the participant's enrollment in the program is forgiven on a pro rata basis over a 36-month period. After the participant completes 6 months of participation in the program, one-sixth of the arrearage is forgiven by the utility company. Thereafter, one-twelfth is forgiven for each succeeding 3 months of participation. Legislation in X was enacted for the specific purpose of allowing utility companies to forgive the arrearage.

The program has been approved by the federal Department of Health and Human Services, and the payments made by X directly to the utility companies are federally-funded under the Low Income Home Energy Assistance Act of 1981, Title XXVI of the Omnibus Budget and Reconciliation Act of 1981, Pub. L. 97-35, 42 U.S.C. §§ 8621-8629. Section 2605(f)(1) of the Act, as amended, 42 U.S.C. §8624(f)(1), provides, in part, that the amount of any home energy assistance payments or allowances provided directly to, or indirectly for the benefit of, an eligible household shall not be considered income for any purpose under any federal or state law, including any law relating to taxation. Participation in the program is the only method available to residents of X to receive federal energy assistance under the Act. The utility companies are not reimbursed by the federal government or X for any revenue lost on account of the arrearage forgiven.

Section 61 of the Internal Revenue Code states that gross income means income from whatever source derived, including income from discharge of indebtedness.

However, the Internal Revenue Service has consistently held that disbursements from a general welfare fund made under a legislatively-provided social benefit program for the promotion of general welfare are not includible in a recipient's gross income. See, for example, Rev. Rul. 78-170, 1978-1 C.B. 24, concluding that payments made under the laws of the State of Ohio directly or indirectly to elderly or disabled low-income individuals to reduce their cost of winter energy consumption are in the nature of relief payments for the promotion of the general welfare and are not includible in gross income.

In Rev. Rul. 91-36, 1991-26 I.R.B. 14, the Service considered the income tax consequences of a customer's participation in an electric utility company's energy conservation programs. Participation in the programs resulted in a reduced price for electricity, in the form of either a rate reduction to the customer or a nonrefundable credit on the customer's bill. The revenue ruling concludes that neither the rate reduction nor the credit is includible in the customer's gross income under section 61 of the Code.

The Act specifically states that home energy assistance payments or allowances made pursuant to the Act to or for eligible households are not taxable income to the households. X has determined that the forgiveness of arrearages is vital to the program's overall success, and has enacted legislation specifically authorizing the utility companies to forgive the arrearages.

Accordingly, we conclude that neither the payments made by X to the utility company nor the forgiveness of arrearages is includible in your gross income.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other tax provisions of the Code.

This ruling is addressed only to the taxpayer that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

You should attach a copy of this ruling to the tax return for the taxable year in which the transaction covered by this ruling is consummated. A reproduced copy may be used for that purpose.

In accordance with the power of attorney submitted, we are sending a copy of this ruling to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By Robert A. Berkovsky
Robert A. Berkovsky
Chief, Branch 2

Enclosure:
Copy for section 6110 purposes

parent for that corporation's entire taxable year and the income of each subsidiary for the portion of such taxable year during which it was a member of the group.

Section 1.1502-76(b)(2) of the regulations provides, in part, that if the consolidated return of a group properly includes the income of a corporation for only a portion of the corpration's taxable year (determined without regard to the change of year), then the income for the portion of such taxable year not included in the consolidated return must be included in a separate return (or, if the corporation is a member of another group that files a consolidated return for such portion of the year, then in such consolidated return). Section 1.1502-76(b)(4) provides, in part, that taxable income to be reported in each such return shall be determined on the basis of the corporation's income shown on its permanent records (including workpapers). If a portion of an item of income or deduction to be reported in each such return cannot be clearly determined from the permanent records, the portion of such item to be reported in each such return shall be the amount of the item for a full taxable year (determined without regard to the change of year) multiplied by a fraction, the numerator of which is the number of days for which the member's income is to be included in such return and the denominator of which is the total number of days in such year.

Section 1.1502-76(d) of the regulations provides that any period of less than 12 months for which either a separate return or a consolidated return is filed under the provisions of this section shall be considered as a separate taxable year.

Section 441(b) of the Code provides, in part, that the term "taxable year" means the period for which a return is made, if a return is made for a period of less than 12 months.

In Rev. Rul. 58-329, 1958-1 C.B. 337, each short period for which a return was filed was considered a separate taxable year for net operating loss carryforward and carryback purposes.

In the instant situation, *X* has been granted permission to elect the full absorption method of inventory costing and, pursuant to section 1.471-11(e)(3) of the regulations, has elected to take the section 481 adjustment into account ratably over a period of 10 taxable years. Each period for which a return is made is considered a taxable year. *See* section 441(b) of the Code and section 1.1502-76(d) of the regulations. Because a taxable year occurs each time a short period return is filed, *X* must take into account one-tenth of the 481 adjustment each time it files such a return.

Accordingly, in the instant situation, one-tenth of the section 481 adjustment is includable in the return of *X* for the period January 1, 1976, through July 31, 1976, and one-tenth of the section 481 adjustment is also includable in the return of *X* for the period August 1, 1976, through December 31, 1976.

Payment to reduce cost of winter energy consumption; Ohio. Payments made under the laws of the State of Ohio directly or indirectly to qualified individuals to reduce their cost of winter energy consumption are not includible in gross income.

Rev. Rul. 78-170

Under the laws of the State of Ohio, elderly and disabled persons are provided credits against their cost of winter energy consumption.

In order to qualify for these credits an individual must (1) be a head of household, (2) be at least 65 years old or be totally and permanently disabled, and (3) have a total income of not more than $7,000.

The state law defines the term "household" as any dwelling unit, or unit in a multiple unit dwelling, to which utility services, energy or energy commodities are separately provided. The benefits are also extended to qualified occupants of house trailers.

The state law provides that qualified individuals who are customers of propane dealers and gas and electric companies will receive credits in the form of a 25 percent reduction on their monthly bills for energy consumption during the months of December 1977 through April 1978, and December 1978 through April 1979. The propane dealers and gas and electric companies will be reimbursed by the state for the credits granted to these qualified individuals. Qualified individuals who purchase their source of energy from suppliers other than those enumerated above and who are able to substantiate that they have expended at least the amount specified in the statute prior to February 1, 1978, will receive a cash payment equal to the specified amount from the state for the 1977-78 winter. The same procedure will be followed for the 1978-79 winter.

Held, the amounts paid under the laws of the State of Ohio, directly or indirectly to qualified individuals, are in the nature of relief payments made for the promotion of the general welfare, and are not includible in the gross incomes of such individuals for federal income tax purposes. See Rev. Rul. 74-74, 1974-1 C.B. 18, which holds similarly with respect to amounts paid to crime victims by the Crime Victims Compensation Board of the State of New York and Rev. Rul. 74-153, 1974-1 C.B. 20, regarding adoption payments made by the Maryland State Department of Social Services.

Industrial development bonds; pollution control facilities; guarantee by Small Business Administration. Interest on industrial development bonds issued by a state to finance pollution control facilities that will qualify as exempt activities under section 103(b)(4)(F) of the Code and be leased to small manufacturing companies located within the state for rental payments guaranteed by the Small Business Administration sufficient to pay debt service on the bonds is excludable from the gross income of the bondholders under section 103(a)(1).

Rev. Rul. 78-171

A state proposes to issue industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954 in the amount of $10,000,000 to finance numerous pollution control facilities for use by small manufacturing companies located within the state. The state will lease the pollution control facilities to the companies for rental payments that will be sufficient to pay debt service (principal and interest payments) on the bonds. The pollution control facilities will qualify as exempt activities under section 103(b)(4)(F). The bonds will not be arbitrage bonds within the meaning of section 103(c).

The Small Business Administration, an agency of the United States Government, will guarantee the payment of the rentals due from the companies pursuant to the provisions of 15

Fisher, Sheehan and Colton, Public Finance and General Economics (FSC) provides economic, financial and regulatory consulting. The areas in which *FSC* has worked include energy law and economics, fair housing, local planning and zoning, energy efficiency planning, community economic development, poverty, regulatory economics, and public welfare policy.