Income Tax Impacts of Cesspool Compliance Program Delivery Modes

ENVIRONMENTAL FINANCE CENTER
AT SACRAMENTO STATE

WATER PROGRAMS
Sacramento State

Federal Tax Impact of Grants
(Suffolk County, NY)

- Payments to residential property owners who must use those payments to install and maintain certain cesspool and septic system upgrades on their residential property, can be excluded from the recipient's gross income in accordance with §126 of the Internal Revenue Code

- Section 126(a)(1) through (8) of the Code provides that gross income does not include "excludable portions" of payment received under the programs

- The Secretary of Agriculture determined that the New York program payments:
  1. are primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife
  2. do not increase substantially the annual income derived from the property

- This determination allows the IRS to consider the New York program as one that meets the criteria of §126(a)(8) and qualified those payments as an "excludable portion" pursuant to §126(b)

State Tax Impact of Grants
(HI AG, Tax Division)

- Initial view: in order for the funds to be excluded from a recipient's gross income, the distribution of the funds must be structured as grants.
- AG's Tax Division is in the process of drafting a memo to provide further guidance on this exclusion, this view is not final
- HRS Chapter 42F Grants, provides the required conditions for the administration of state grants, including the execution of contracts between the state agency and the recipient
- The preliminary parameters of the Cesspool Compliance Pilot Grant Program may need to include:
  - (1) the requirements set forth in HRS Chapter 42F; and
  - (2) the conditions articulated in 2022 Act 153

	Definition/Process	Income Tax Impact	Timing Related Financial Impact	County Process	Credit Impact
Forgivable Loan (non graduated)	• Homeowner applies for a loan from the County • Homeowner pays contractor • County transfers proceeds to the homeowner • Entire loan principal is forgiven at the end of the loan term	• Entire loan principal is taxable income when forgiven, all in one year	• Homeowner must pay contractor up front, wait to get reimbursed • Tax liability in final year of loan term	• Review, evaluate, and award loan applications • Process loan disbursements • Review, evaluate and certify completed work. • Process loan forgiveness	• Loan amount would presumably be reported on homeowner's credit report
Forgivable Loan (graduated)	• Homeowner applies for a loan from the County • Homeowner pays contractor • County transfers proceeds to the homeowner • Portions of the loan principal are forgiven annually	• The forgiven portions of the loan are taxable income	• Homeowner must pay contractor up front, wait to get reimbursed • Tax liability is spread across multiple years of loan term	• Review, evaluate, and award loan applications • Process loan disbursements • Review, evaluate and certify completed work • Process loan forgiveness	• Loan amount would presumably be reported on homeowner's credit report
Grant	• Homeowner applies for a grant from the county • Homeowner pays contractor and is reimbursed by County through the grant	• Federal: Grant will not be considered taxable income, IR Code Section 126(a) • HI: Grants may not be considered taxable income according to HRS Ch. 42F	• Homeowner will have to pay contractor out of pocket first and wait to get reimbursed.	• Review, evaluate, and award grant applications • Review, evaluate and certify completed work • Process reimbursements	• Interim financing costs *may* impact homeowner's credit

Summary

- Forgivable Loan (non-graduated): largest single year tax impact on homeowners, short and long term administrative responsibilities
- Forgivable Loan (graduated): smaller single year tax impacts on homeowners, short and long term administrative responsibilities
- Grant: no federal tax impact on homeowner, possibly no HI tax impact, short term administrative responsibilities

Summary of the Process to Receive a Determination under Title 26, U.S.C. Section 126 to Lessen the Federal Tax Burden of Payments Made from the SRF Program to Property Owners

Region 9 Environmental Finance Center
Housed in the Office of Water Programs at
California State University, Sacramento

As best as we can determine, Title 26, U.S.C. § 126 does not automatically allow payments from the SRF program made directly to a property owner to be excluded from taxable income. A representative of the Kauaʻi District Health Office or equivalent will need to reach out to the Pacific Islands Area State Office of the Natural Resources Conservation Service (NRCS) of the U.S. Department of Agriculture (USDA) to get the process started. Here is the contact list: https://www.nrcs.usda.gov/contact/state-office-contacts/pacific-islands-area-state-office.

The commissioner's request should solicit a determination that payments made under the program are primarily for the purpose of conserving soil and water resources and protecting or restoring the environment, thereby meeting the requirements of Title 26 U.S.C. § 126(b)(1)(A) to be excluded from a property owners' gross federal taxable income. If need be, the Determination of the Primary Purpose of the New York Suffolk County Septic Improvement Program (SIP), 87 FR 68669 (November 16, 2022) can be shared with the representative as proof of precedent. Since this pilot program will primarily focus on Priority 1 areas with cesspools that have been determined to be of significant risk of human health impacts, drinking water impacts, or draining to sensitive waters, this step of the process should be relatively painless.

The USDA NRCS representative can then direct your organization on next steps to get the IRS publication completed by putting you in touch with a Secretary of the Treasury representative for a determination that the payments under your program do not substantially increase the annual income derived from properties receiving funds [see Title 26 U.S.C. § 126(b)(1)(B)]. The IRS has previously made a determination for a similar program in Suffolk County, New York following this process (Announcement 2022-26, Amounts Paid by Suffolk County, New York, to Residents for Septic System Upgrades, December 2, 2022).

Once those steps are complete and the IRS determination published, then you can notify any program applicants/participants of the determination notice and the option to exclude payments made through this program from their federally taxable gross income (26 U.S.C. § 126(c) leaves the decision to exclude or not exclude up to the taxpayer).

Our understanding is that these steps must wait until a funding agreement is reached between the County and DOH and the County-Homeowner applicant agreement is finalized so that USDA/IRS representatives can review the documents and program in its entirety. If the Hawaiʻi Department of Health reaches out to the USDA NCRS for a blanket determination that any SRF funds used for the purpose of replacing cesspools can be excluded from federal taxable gross income, then it may be possible to start this process sooner.

Note: Obtaining a determination under Title 26 U.S.C. § 126 will only allow homeowners the option to exclude payments from federal gross income. Payments made directly to the homeowner will still need to be declared for state tax purposes (barring any changes or recent updates to the Hawaiʻi state tax code that we haven't found in our research). If the County of Kauaʻi or other pass-through organization pays the contractor directly in future program iterations or an additional determination is made by the Hawaiʻi Department of Taxation that payments for cesspool replacement can be excluded from state gross income, then there will be no tax implications for the homeowner.