U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
Office of Community Planning & Development

Special Attention of:
CPD Division Directors,
State CDBG Grantees

Notice CPD-04-11

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Cross References:

Subject: Program Income Requirements in the State CDBG Program

PURPOSE

The purpose of this notice is to clarify the states' duties and responsibilities in regard to program income. Some confusion exists among states in this matter, due in large part to the fact that the regulations in Subpart I of 24 CFR 570 dealing with program income do not reflect statutory changes made in 1992, and thus are outdated. A proposed rule to update the regulations will eventually be issued; however, recognizing the need to inform field staff, grantees and state grant recipients, HUD has decided to issue this guidance.

SECTION 1: STATUTORY REQUIREMENTS PRIOR TO 1992

Prior to October, 1992, Section 104(j) of the Housing and Community Development Act of 1974, as amended (HCDA), stated, in part:

> (j) Notwithstanding any other provision of law, any unit of general local government may retain any program income that is realized from any grant made by the Secretary, or any amount distributed by a State, under section 106 if (1) such income was realized after the initial disbursement of the funds received by such units of general local government under such section; and (2) <u>while such unit of general local government is participating in a community development program under this title</u> it will utilize the program income for eligible community development activities in accordance with the provision of this title…
> [Note: Underlining added for emphasis]

Based on this statutory citation, units of general local government were and are required to treat as program income any funds received and retained before closeout of the grant that generated them; consequently, such program income is subject to all applicable requirements of 24 CFR 570.

However, Section 104(j)(2) of the HCDA was worded to allow units of local government to use any income generated by Community Development Block Grant (CDBG) funds after closeout

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without regard to any CDBG requirements, unless the unit of general local government (UGLG) had another open CDBG grant or was continuing the same activity that generated the program income. In other words, the program income became the property of the unit of local government, to do with as it wished.

SECTION II: STATUTORY REQUIREMENTS AFTER 1992

With the 1992 amendment, Congress struck out the phrase, "…while such unit of general local government is participating in a community development program under this title…", thus changing the meaning of Section 104(j)(2) and requiring UGLGs to administer program income in adherence to CDBG requirements indefinitely.

Secretary's exception. Before 1992, any amount retained by an UGLG before closeout of its CDBG grant, no matter how small, was considered program income and subject to CDBG requirements. Realizing that making program income subject to these requirements indefinitely would substantively increase the administrative burden of UGLGs and their subrecipients, Congress, in the same amendment, excluded trivial amounts from being considered program income, and gave the Secretary the authority to exclude "any amounts determined to be so small that compliance with this subsection creates an unreasonable administrative burden on the unit of general local government." Consequently, HUD established by regulation at 24 CFR 570.489 (e)(2)(i) that any amount of funds less than a certain limit received in a single year that is retained by an UGLG and its subrecipients is not considered program income. However, if the amount received is above the set limit, then every dollar is considered program income. Since 1995, that limit has been set at $25,000. Thus, if a unit of local government and its subrecipients receive $25,000 or more within the state-established 12-month time period, then every dollar is considered program income.

SECTION III: STATE CDBG REGULATIONS

Apart from 1995 rule revisions to the definition of program income, Subpart I has not been updated since 1992 to reflect statutory changes in the reporting of program income. This situation has created some confusion among grantees. For instance, 24 CFR 570.489(e)(3)(ii) states, in part:

> (ii) *Program income retained by a unit of general local government.* (A) Program income that is received and retained by the unit of general local government before closeout of the grant that generated the program income is treated as additional CDBG funds and is subject to all applicable requirements of this subpart.
>
> (B) Program income that is received and retained by the unit of general local government after closeout of the grant that generated the program income is not subject to the requirements of this subpart, except:
>
> (1) If the unit of general local government has another ongoing CDBG grant from the state at the time of closeout, the program income continues to be subject to the requirements of this subpart as long as there is an ongoing grant; and

(2) If program income is used to continue the activity that generated the program income, the requirements of this subpart apply to the program income as long as the unit of general local government uses the program income to continue the activity;
(3) The state may extend the period of applicability of the requirements of this subpart.

The language of Paragraph (B), which provides that funds received after closeout may or may not be subject to the program income requirements, is clearly at odds with Section 104(j) of the HCDA, as amended. It is therefore important for grantees to note that the Act supersedes 24 CFR 270.489(e)(3)(ii)(B), and that all program income—both before and after closeout—is subject to the requirements of Subpart I.

In the forthcoming rule, the Department will propose to strike Section 570.489(e)(3)(ii)(B) and its subsequent clauses, and also delete the phrase "before closeout of the grant that generated the program income" in Section 570.489(e)(3)(ii)(A) in order to bring State CDBG regulations in accord with the statute.

States have the ability to establish definitions and requirements in several cases that will determine what gets classified as program income and who retains control over it. As noted earlier, the Secretary has determined that an annual amount of funds received by an UGLG that is less than $25,000 need not be treated as program income. However, the state possesses the authority to set this threshold even lower, to the point where any funds received become program income.

SECTION IV: ACTIVITIES CARRIED OUT BY 105(a)(15) NONPROFIT ENTITIES

Section 105(a)(15) of the HCDA allows as eligible the provision of assistance to neighborhood-based nonprofit organizations, local development corporations, and nonprofit organizations serving the development needs of communities in non-entitlement areas to carry out neighborhood revitalization, community economic development or energy conservation projects. According to 24 CFR 570.489(e)(2)(ii), "amounts generated under Section 105(a)(15) of the Act and carried out by an entity under the authority of Section 105(a)(15) of the Act" are not considered program income.

States seeking to minimize the amount of funds that must be treated as program income could take advantage of this exemption by encouraging UGLGs to form sub-grantee relationships with local nonprofit organizations to administer Revolving Loan Funds (RLFs). In this scenario, the state would grant funds to an UGLG, which then would pass the funds on to a nonprofit organization, such as a community development corporation (CDC). The CDC would then use those funds to make loans, such as for business expansion or housing rehabilitation. If the repayment of that loan is made to the nonprofit organization and the nonprofit retains the repayments for further use, repayments are not considered program income; subsequent loans by the nonprofit entity using those funds do not have to meet any Federal requirements. However, the state or UGLG could still establish requirements for re-use of the funds—or even require

some CDBG requirements to be followed through grant agreements between the UGLG and the 105(a)(15) entity. HUD encourages grantees to ensure that subsequent revenue is expended on community development needs.

SECTION V: PROGRAM INCOME RETURNED TO STATES

A state may reclaim program income from a unit of general local government in almost every instance in which it wishes to do so, with only one exception. Section 104(j) of the HCDA states, in part:

> …A state may require as a condition of any amount distributed by such State under section 106(d) that a unit of general local government shall pay to such state any such income to be used by such State to fund additional eligible community development activities, except that such State shall waive such condition to the extent such income is applied to continue the activity from which such income was derived…
> [Note: See also 24 CFR 570.489(e)(3)]

In essence, when an UGLG reinvests its program income into "continuing the same activity", e.g., housing rehabilitation, that entity has a right to retain its program income. However, states have maximum feasible deference in determining the definition of an "activity".

For instance, a state that gives funds to one recipient to rehabilitate five houses may define the activity in broad terms as "housing rehabilitation", allowing the recipient to use the subsequent program income to fund five more houses. Conversely, the state may define the activity narrowly as "rehabilitation of five houses" and require the recipient to give the program income back to the state. In essence, a state can define what constitutes an activity differently for different categories of funding, but it must state this definition in its Method of Distribution or administrative guidelines. However, even in this scenario, the state would be required to allow the unit of local government to retain program income to complete the rehabilitation of the original five units, if more money was needed to complete the initially-planned work.

SECTION VI: WHEN A STATE GRANT RECIPIENT BECOMES AN ENTITLEMENT

Due to the large number of new Entitlement jurisdictions in FY 2004, there is some confusion as to whether these former State grant recipients must return to the state any program income from grants received when they were still non-entitlement grantees. States understand that the program income ultimately "belongs" to them, even if the local government retains it, because the State is HUD's grantee. However, States also realize that they may never do CDBG business with these newly-entitled cities again, and do not wish to perpetually keep track of program income when they would otherwise have no further contractual dealings with the UGLG. States faced with this situation have four methods of recourse: 1) The state and UGLG can agree that the UGLG will fund an activity that totally expends its program income without generating more of same; 2) the state can continue to track the local program income until it is all used up; 3) in some instances, states can require former grantees to return the program income; and 4) the State

and local government can agree to transfer the state-grant-generated program income to the locality's new Entitlement program. Whereas the first two options are self-explanatory, the last two need more clarification.

Returning Program Income to the State. A State wishing to have its program income returned must bear two things in mind: 1) If the program income is being used to continue the same activity which generated the program income (e.g. a housing rehabilitation revolving loan fund), Section 104(j) of the HCDA prevents a state from requiring localities to return it; and 2) to reclaim program income that is not being used to continue the same activity, a State must already have provisions within its Method of Distribution or administrative guidelines that allow the State to do so.

Transferring Program Income to the new Entitlement. The State and local government can agree to transfer the State-grant-generated program income to the locality's new Entitlement program. In this scenario, the city agrees to track this new program income to its Entitlement program, so that HUD is assured that the funds will continue to be treated as CDBG resources and a means still exists to document the locality's compliance with CDBG requirements. The State similarly can be assured that the funds will continue to be used in compliance with requirements without having to continue to monitor a community that it will never do business with again. If a State and new entitlement community decide to take this approach, several things should be kept in mind: 1) This approach cannot be pursued until the community has officially decided to become an entitlement community; 2) The community must be aware that its program income must now be used in accordance with Entitlement program rules, not the State's; 3) HUD strongly recommends that the State and community have a written agreement concerning this transfer of funding responsibility; and 4) The community should set up its IDIS access and enter the receipt of the program income in IDIS as soon as practical.

Similarly, an UGLG which is becoming a participant in a new urban county can transfer its program income to the urban county CDBG program. HUD recommends that written agreements specify any rights the UGLG will have to use this program income.

SECTION VII: STEP-BY-STEP GUIDE TO DETERMINING PROGRAM INCOME

In 2002, HUD's Office of Block Grant Assistance, States and Small Cities Division, conducted a State CDBG training seminar for HUD Field Office staff. In concert with that seminar, SSCD issued the following step-by-step guide to help interpret the rules and statute in regard to determining what is program income and in its re-use. Grantees and Field Office staff are encouraged to use this guide if there is any doubt over whether funds in question constitute program income.

PART A: IS IT PROGRAM INCOME?

STEP ONE: WAS THE INCOME GENERATED BY THE USE OF STATE CDBG FUNDS, AND IS THIS TYPE OF INCOME INCLUDED AT § 570.489(e)(1)?

- Sale, lease, rental proceeds of property acquired with/improved by CDBG funds
- Principal and interest payments on loans made from CDBG funds
- Proceeds from sale of CDBG loans or other obligations
- Interest earned on funds in a revolving loan fund account or on program income pending reuse
- Special assessments collected from non-LMI households to cover part of the CDBG portion of a public improvement
- Income paid to a UGLG or "subrecipient" from the ownership interest in a for-profit, that was acquired in exchange for CDBG assistance.
- Other types of income not specifically mentioned

    - ❑ YES, Go to Step Two.
    - ❑ NO, Stop here. These funds ARE NOT program income

STEP TWO: IS THIS TYPE OF INCOME LISTED IN THE PROGRAM INCOME EXCLUSIONS AT §570.489(e)(2)(ii) OR (iii)?

- Generated by activities eligible under Section 105(a)(15) of the Act, carried out by an entity under the authority of this section. (a CBDO or otherwise-qualifying nonprofit organization)
- Generated by Section 108 Loan Guarantee-funded activities, if activity meets certain standards. See 570.489(e)(2)(iii)

    - ❑ YES, Stop here. These funds ARE NOT program income.
    - ❑ NO, Go to Step Three.

STEP THREE: WAS THE INCOME EITHER RECEIVED DIRECTLY BY OR RETURNED TO THE STATE?

- ❑ YES, Stop here. These funds ARE program income. For program income re-use guidance, see Step Four in **Part B**.
- ❑ NO, Go to Step Four.

STEP FOUR: WAS THE INCOME RECEIVED/RETAINED BY A UNIT OF LOCAL GOVERNMENT AND/OR ITS SUBRECIPIENTS?

- ❑ YES, Go to Step Five.

- NO, The income is not likely to be program income. One example might be the earnings from operations of a CDBG-assisted for-profit business. If uncertain, seek additional guidance on your particular situation.

STEP FIVE: WAS THE LOCAL GOVERNMENT/SUBRECIPIENT INCOME GENERATED BY ACTIVITIES FUNDED THROUGH FY 1992 AND PRIOR ALLOCATIONS *WHILE THE UNIT OF GOVERNMENT DID NOT HAVE AN ONGOING GRANT RELATIONSHIP WITH THE STATE*?

- YES, Stop here. These funds ARE NOT program income. They precede the applicability of the 1992 HCDA Act changes.

- NO, Go to Step Six. The 1992 changes to Section 104(j) of the HCDA Act override the "ongoing grant" requirement at §570.489(e)(3)(ii)(B) beginning with FY 1993 allocations.

STEP SIX: DID THE UNIT OF LOCAL GOVERNMENT AND/OR ITS SUBRECIPIENTS RECEIVE /RETAIN $25,000 OR MORE IN INCOME DURING THE ANNUAL (STATE DEFINED) MEASUREMENT PERIOD?

- YES, Stop here. These funds ARE considered to be program income, INCLUDING the first $25,000. For program income re-use guidance, see Step Two in **Part B**.

- NO, Stop here. These funds ARE NOT considered to be program income. See §570.489(e)(2)(i). However, the funds may be subject to additional state requirements under state policy or a state/recipient agreement.

PART B: PROGRAM INCOME RE-USE

STEP ONE: WAS THE INCOME RECEIVED/RETAINED BY A UNIT OF GENERAL LOCAL GOVERNMENT OR ITS "SUBRECIPIENTS"?

- ❑ YES, Go to Step Two.
- ❑ NO, Go to Step Three.

STEP TWO: WAS THE LOCALITY'S INCOME GENERATED BY A REVOLVING LOAN FUND ACTIVITY (RLF)?

- ❑ YES. The income must be substantially disbursed before additional grant funds are drawn for the Treasury for activities under this specific RLF. [§570.489(f)(1)]. Go to Step Five.
- ❑ NO. To the maximum extent feasible, the state must require the unit of local government to disburse program income before requesting additional grant funds from the state. [§570.489(e)(3)(ii)(C)] *Go to Step Five*.

STEP THREE: WAS THE INCOME RECEIVED BY OR RETURNED TO THE STATE?

- ❑ YES. Go to Step Four.
- ❑ NO. See Step Two in this re-use section for guidance on locality level program income. If income was not received/held at the locality or state level, review the criteria in Part A to determine whether the funds are in fact program income.

STEP FOUR: WAS THE INCOME GENERATED FROM A GRANT FUNDED (OR ELIGIBLE TO BE FUNDED) BY A STATE REVOLVING FUND (SRF)?

- ❑ YES. In the short term, the SRF program income must be disbursed to cover draw requests from other SRF activities before additional grant funds are drawn from the Treasury for these activities. In the long term, if excess SRF program income funds exist, they must be used to make additional SRF grants to units of general local government according to the state's method of distribution. [§570.489(f)(2)] *Go to Step Five*.
- ❑ NO. In the short term, non-SRF program income must be disbursed to cover draw requests from any non-SRF activities. This program income *may* also (if the state *chooses* and includes this choice in their method of distribution) be disbursed to cover draw requests for *SRF* activities. In the long term, if excess non-SRF program income funds exist, they must be used to make additional grants to units of general local government according to the state's method of distribution. [§570.489(e)(3)(i)] *Go to Step Five.*

STEP FIVE: FOR EACH PROGRAM INCOME CLASSIFICATION (LOCALITY VS STATE-RETAINED, RF VERSUS NON) DOES THE STATE INCLUDE THIS TYPE OF PROGRAM INCOME WHEN DETERMINING THE BASE UPON WHICH IT CALCULATES THE 2% ADMINISTRATIVE ALLOWANCE?

YES or NO. Use the same methodology as the state when recalculating/reviewing compliance with the 2% administrative allowance.

CONCLUSION

Program income can pose challenges for any administrator, especially in light of the fact that the regulations for the State CDBG Program do not reflect statutory changes. At some point in the future, HUD will revise those regulations; until then, grantees are encouraged to consult with HUD Field Office or Headquarters staff if they have any questions concerning the administration of program income.