Module F

IRC Section 143 - Qualified Mortgage Bonds

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Overview

Introduction

Module E discussed the various types of exempt facility bonds. Module F will cover another type of qualified private activity bond - qualified mortgage bonds. This entire section should be considered to be an overview of the requirements related to qualified mortgage bonds. This section is NOT comprehensive, and in the event of an examination of qualified mortgage bonds, the agent should contact the National Office for guidance.

Objectives

At the end of this module, the student will be able to:

- Define a qualified mortgage issue.
- Explain the residence requirement.
- Explain the “first-time homebuyer” requirement.
- Explain the purchase price requirement.
- Describe the income limitations.
- Explain the arbitrage restrictions of IRC section 143(g).
- Identify other private activity bond rules that apply to these bonds.

In this module

This module contains the following topics:

General Rules

Statutory provisions

IRC section 143 provides the requirements for mortgage revenue bonds.

Before the Tax Reform Act of 1986, the provisions for mortgage revenue bonds were contained in section 103A of the 1954 Code.

Regulations

Treas. Reg. sections 1.103A-2 and 6a.103A-2 provide rules for mortgage revenue bonds. It is important to note that these regulations were issued before the 1986 Act. To the extent the rules in section 143 are the same as in section 103A of the 1954 Code, Treas. Reg. sections 1.103A-2 and 6a.103A-2 apply.

Definition of Qualified Mortgage Bond

IRC section 143(a)(2) defines a qualified mortgage issue as a bond:

- issued to provide mortgage financing for single family residential property which is occupied by the owner as his/her principal residence, **AND**
- which meets the additional requirements in IRC section 143, as described below.

Use of proceeds

At least 95 percent of the net proceeds of the bonds (bond proceeds less amounts in the reasonable required reserve fund) must be used to finance the owner-occupied residences described in section 143.

Expenditures

IRC section 143(a)(2)(D) provides that all proceeds required to be used to finance owner-occupied residences must be used within the 42-month period beginning on the date of issuance of the bonds.

If not so used, the proceeds should be used to redeem bonds that are part of the bond issue.

Principal Residence

Residence requirement

IRC section 143(c) provides that:
- each mortgage loan made with the proceeds of the bonds must be made to finance property that is reasonably expected, at the time of the making of the loan, to be used as the mortgagor's principal residence, AND
- the single family home financed with the proceeds of the bonds must be located in the jurisdiction of the issuer.

Exception to single family requirement

IRC section 143(k)(7) provides that the term "single family" and "owner occupied" may include a two, three or four family residence if:
- one unit of which is occupied by the owner of the units, AND
- the residence was occupied at least five years before the mortgage is executed.

However, the residence does not have to meet the five-year residency test if:
- the residence is a two-family residence,
- the residence is located in a targeted area, AND
- the income of the mortgagor is 140% or less than the area median income.

Principal residence

Under Treas. Reg. section 6a.103A-2(d)(3), whether a residence is a principal residence depends upon the facts and circumstances of each case.

A residence primarily intended to be used in a trade or business will not qualify. If the mortgagor is not entitled to deductions for expenses related to a trade or business, then the residence will not be considered to be used in a trade or business.

A residence used as an investment property or a recreational home does not qualify.

Three-Year Requirement

General Rule

IRC section 143(d)(1) requires that mortgagors should not have a present ownership interest in a principal residence at any time during the three-year period immediately before the date of obtaining the loan with the bond proceeds. This is referred to as the "first-time homebuyer" requirement.

Exception to Three-Year Requirement

Section 143(d)(2) provides that the three-year requirement does not apply with respect to:
- financing provided in a targeted area,
- qualified home improvement and qualified rehabilitation loans, AND
- financing with respect to land described in subsection (i)(1)(C) and the construction of any residence on it.

See Treas. Reg. section 6a.103A-2(e) for more information.

Multiple mortgagors

Each mortgagor who has an ownership interest in the bond-financed property should meet the three-year requirement.

For example, a parent of a home purchaser cosigns the note for a child who otherwise meets the three-year requirement. If the parent takes no interest in the residence, then the parent need not meet the three-year requirement.

However, if a husband and wife both have an ownership interest in the bond-financed property, both should meet the three-year requirement.

Ownership interests

Treas. Reg. section 6a.103A-2(e) differentiates between interests that constitute ownership interests and interests that do not, as follows:

INTERESTS WHICH ARE OWNERSHIP INTERESTS	INTERESTS WHICH ARE NOT OWNERSHIP INTERESTS
fee simple	remainder interest
joint tenancy	lease with (or without) an option to purchase
tenancy in common	expectancy to inherit
tenancy by the entirety	interest under a purchase contract
tenant-shareholder cooperative	interest in other than a principal residence
life estate	
land contract	

Purchase Price Requirement

General Rule

The purchase price of a residence must not exceed 90 percent of the average purchase price of all single-family residential sales during the last 12 months in the same statistical area as the financed property. **(See IRC section 143(e).)**

Special Rules

For a residence that is a targeted area residence, the purchase price may be as high as 110 percent of the average area purchase price**. (See IRC section 143(e)(5).)**

See IRC section 143(j) and Treas. Reg. section 6a.103A-2(h) for the definitions of various terms and special rules.

An adjustment is permitted to the average area purchase price for single family residences occupied by two, three, or four-family residences.

Income Limitations

General Rule

All of the mortgage loans financed with proceeds of the bonds must be made to persons whose family income is 115 percent or less of the applicable median family income. **(See IRC section 143(f).)**

Family income and area median income are determined in accordance with Section 8 regulations under the Housing Act of 1937. **(See Exhibit E-1.)**

Special Rule

In case of any financing for targeted area residences:

- one-third of the mortgages may be provided without regard to the 115 percent limitation described above, AND
- the 115 percent limitation is deemed satisfied with respect to the remaining two-thirds of the mortgages if the bond proceeds are loaned to families with a family income of 140 percent or less of the area median income. **(See IRC section 143(f)(3).)**

Adjustments

IRC section 143(f)(5) permits certain adjustments for income limits if the residence is located in an area where the housing costs are disproportionately higher than the national average.

Arbitrage Restrictions

General Rule

In addition to the restrictions in IRC section 148, section 143(g) imposes additional arbitrage restrictions regarding the interest rate on the single-family loans.

Interest Rate on Mortgages

IRC section 143(g)(2) provides that a bond will be a qualified mortgage bond only if the <u>effective rate of interest</u> on the mortgage does not exceed the yield on the bonds by more than 1.125 percentage points.

Effective Rate of Interest

IRC section 143(g)(2) provides that all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or bond issue are taken into account in determining the effective rate of interest on the mortgage.

Therefore, the effective rate of interest is computed by present valuing the mortgage payments to be made by the mortgagor to the purchase price of the mortgage.

The purchase price of the mortgage is decreased by the points paid by the mortgagor. Points paid by the seller are deemed paid by the mortgagor, and are also subtracted.

Mortgage insurance premiums and normal financing costs are not taken into account.

Prepayment Assumptions

In determining the effective rate of interest on the mortgages, it is assumed that the mortgages will have expected maturities that are equal to 100 percent of the rate set forth in the most recent prepayment experience tables published by FHA. **(See section 143(g)(2)(B)(iv) and Treas. Reg. section 6a.103A-2(i)(2)(iv).)**

Yield on the Issue

The yield on the issue is determined on the basis of the issue price and expected maturity for the bonds that is consistent with the prepayment assumption described above. **(See IRC section 143(g)(2)(C).)**

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Mortgage Forgiveness

As stated above, in determining the effective rate of interest on the mortgages the prepayment assumptions are taken into account. Therefore, if the bonds are discharged faster than the actual prepayments of mortgages, the issuer may not meet the requirements of IRC section 143(g).

In order to maintain a spread of 1.125 percentage points or less between the yield on the bonds and the yield on the mortgages, an issuer may direct the trustee to forgive the mortgages when all related bonds are discharged.

Under this scenario, the yield on the mortgage loans takes into account the payments made under the mortgage loans only until the bonds are presumed discharged based on the FHA prepayment assumptions.

Note

In addition to the restrictions under section 143(g), the issuer must meet the arbitrage and rebate requirements of IRC section 148.

Other Requirements

Other private activity bond rules

The following private activity bond rules are applicable to qualified mortgage bonds under IRC section 143. These rules are not discussed in this section, but are discussed in various other sections:

- Section 146 requires that the issuer receive volume cap allocation for the issue prior to issuance.
- Section 147(e) prohibits the use of bonds to finance certain facilities.
- Section 147(f) provides the notice and public approval requirements.
- Section 147(g) provides for limits on bond proceeds which may be used for costs of issuance.
- Section 148 provides arbitrage restrictions and rebate rules.
- Section 149 provides various other rules.

Summary

Review of Module F

Module F has discussed the requirements of mortgage revenue bonds. These bonds are subject to complex rules, and the module was not meant to provide a comprehensive discussion of them. If you should encounter mortgage revenue bonds, you should contact the National Office for guidance.

Generally, mortgage revenue bonds are subject to the following rules:

- At least 95 percent of the net proceeds of the bonds must be used to finance the owner-occupied residences described in section 143.
- All bond proceeds to be used to finance owner-occupied residences must be used within 42 months of the date the bonds are issued. If not, the proceeds not so used must be used to redeem the bonds.
- Each mortgage loan must be made to finance property to be used as the mortgagor's principal residence, and the residence must be located within the jurisdiction of the issuer.
- Mortgagors must be "first-time homebuyers."
- The purchase price of a residence generally must NOT exceed 90 percent of the average purchase price of all single-family residential sales during the last 12 months in the same statistical area as the financed property.
- Generally all of the loans financed with bond proceeds must be made to persons whose family income is 115 percent or less of the applicable median family income.
- **In addition to the restrictions in IRC section 148,** section 143(g) imposes additional arbitrage restrictions regarding the interest rate on the single-family loans.

In addition to the rules set forth in IRC section 143, mortgage revenue bonds are also subject to all of the other rules governing municipal bonds, such as those found in sections 146 through 150.

Preview of Module G

Module G continues the text's discussion of qualified private activity bonds by discussing qualified small issue bonds. Qualified small issue bonds may not be as common after 1986 because the TRA 1986 limited their use to manufacturing facilities.