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TAX-EXEMPT MORTGAGE BONDS: A WAY TO ALLEVIATE THE SELF-INFLICTED DAMAGE CAUSED BY CALHFA'S READING OF IRC SECTION 143

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[1] The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or the Taxation Section of the State Bar.

[2] Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

Internal Revenue Code ("IRC") section 143 provides tax-exempt status for state-issued bonds whose proceeds are used to fund loans for owner-occupied single-family residences. Most states interpret the "owner-occupied" requirement as being met if it is reasonably expected, at the time of the making of the loan, that the home will be used as the mortgagor's principal residence.

Founded in 1975, the California Housing Finance Agency ("CalHFA") offers low-interest loans to first-time homebuyers using funds raised through the sale of bonds that are tax-exempt under IRC section 143. Afraid of jeopardizing its tax-exempt bond status, CalHFA has been foreclosing on homeowners who are renting out homes financed by the agency **even though the homeowners are current on their mortgages**. This is based on CalHFA's reading of the residence provisions of section 143 as requiring that borrowers occupy the home for the life of the mortgage.

The agency's policy, crafted on the advice of outside tax bond counsel, was designed to insure that CalHFA complied with bond counsel's interpretation of IRS guidelines on how the bond proceeds were to be used, so as not to endanger its bonds' tax-exempt status. Borrowers who finance their homes through CalHFA are not allowed to rent them out. Prior to the current severe housing downturn, people who had purchased homes with agency mortgages and needed to move (due to a change of circumstances, such as job relocation or as families grew) were able to sell their homes and pay off their mortgages.

In recent years, homeowners who moved from their homes due to a change of circumstances such as obtaining new employment have been unable to sell either because of a stagnant market or because they are underwater on their loan. Many homeowners in these circumstances prefer to protect their credit scores, rent out their homes and continue to service their repayment obligations under the note, even if the homeowner loses money by doing so. Due to its interpretation of the relevant Internal Revenue Code provisions, CalHFA has, however, been providing homeowners with two options to avoid foreclosure: moving back in or repaying the loan in full.

As a result, CalHFA has been foreclosing on homeowners who rent out homes even though they are current on their mortgages. In addition to creating a bad situation for the people the agency was designed to help, the agency's actions are also a money-losing proposition, because each foreclosure results in an average uninsured loss of $50,000 to the agency.

This paper will address these important public concerns and provide a different interpretation of the relevant sections of the Internal Revenue Code to show that the agency's tax-exempt bond status would not be jeopardized in this situation. CalHFA does not need to foreclose on homeowners who are current on their mortgages because they are forced to rent their residence due to a change in circumstance. The alternative interpretation to be discussed is currently followed in every state except California and two others. The paper proposes that the State Legislature adopt legislation that would require CalHFA to apply section 143 in the same manner as 47 of its 49 sister states, thereby allowing homeowners current on their mortgages with CalHFA to avoid foreclosure and reducing losses to CalHFA resulting from its own actions.

A. The California Housing Finance Agency and Its Treatment of Homeowners Who Rent Because Their Home Is Underwater[3]

CalHFA was established in 1975 pursuant to the provisions of the Zenovich–Moscone–Chacon Housing and Home Finance Act of 1975.[4] It is an agency of the State of California, located within the Business, Transportation and Housing Agency.[5] CalHFA is administered by a board consisting of eleven voting members, eight of whom are appointed, and three non-voting members.[6]

While CalHFA's primary purpose is to meet the housing needs of low-and moderate-income persons and families,[7] it is statutorily mandated "to seek to financing for home purchases in order to make homeownership feasible for persons and families of low or moderate income, and b) fully utilizing federal subsidy assistance for the benefit of persons and families of low or moderate income.[8] Bonds issued by CalHFA and income earned from such bonds are not subject to state or local taxes, except for gift and inheritance taxes.[9]

Prior to the collapse of the real estate bubble, CalHFA provided housing assistance in three areas: a) below-market-interest-rate purchase money mortgages for first-time homebuyers, most of whom were low and moderate income families and ethnic minorities; b) insurance for single-family home purchase mortgages; and c) loans for the development of multifamily rental housing. CalHFA's loans are funded through the sale of revenue bonds. Its operating expenses are paid by origination and service fees and the excess of the interest earned on the loans over the interest paid on outstanding debt. This allowed CalHFA to operate without relying on the general revenues of the State of California. Bonds issued by CalHFA are obligations only of the agency, and not the State of California.

For interest on CalHFA bonds to be tax exempt, the bond issue must comply with the requirements of the Internal Revenue Code provisions on tax-exempt

[3] One of the authors, Joseph P. Wilson, purchased a home with a CalHFA loan. After he moved following a job relocation, he has been renting the home at a loss, since he cannot refinance the home or sell it for an amount sufficient to pay the debt. He has been attempting to obtain a rental waiver from CalHFA.
[4] Originally codified at California Health & Safety Code secs. 41000 *et seq.*, the statutes governing the operations of CalHFA currently are at California Health & Safely Code secs. 50900 *et seq*.
[5] California Health & Safely Code section 50900.
[6] California Health & Safely Code section 50901.
[7] California Health & Safely Code section 50950.
[8] California Health & Safely Code section 50952.
[9] California Health & Safely Code section 50954.

mortgage bonds. These are currently contained in Internal Revenue Code section 143. The requirements are discussed in detail in Part C below.

One of the requirements of section 143 is a "residence requirement." CalHFA's bond counsel, Orrick, Harrington & Sutcliffe, advised CalHFA that any commercial use of a home acquired with a CalHFA mortgage was contrary to this requirement, and that rental was a "commercial use". Thus, a mortgagor's rental of a CalHFA financed home jeopardized the bond issue's exempt status. In the current real estate slump, this interpretation has caused extreme hardship to a number of homeowners who have CalHFA mortgages. In 2005, CalHFA obtained an opinion on a bond issue from a different outside bond counsel, Hawkins, Delafield & Wood, that all that was needed was for the mortgagor to intend to live in the home at the time of the loan, and not stay there for the life of the mortgage.[10] Subsequent rental of the home does not affect the bond's exempt status.

A first-time homebuyer normally expects, when he or she purchases a home, eventually to sell the home as a result of changed circumstances, such as marriage, children, or relocating for work. Previously during the upswing in the real estate market, a homeowner in such a situation could refinance or sell the home in a reasonable period of time to pay off the balance owed on the mortgage. In the current market, with many homes underwater, this is often impossible without seriously impacting the homeowner's credit and future ability to repurchase.

More than 200 CalHFA borrowers in this situation have rented their homes in order to be able to stay current on their mortgage payments to keep their credit in tact, with the expectation of selling the home when the real estate market improves.[11] Based on bond counsel's advice, CalHFA has deemed these homeowners in default. As of late 2011, CalHFA had foreclosed on at least 21 homeowners for renting out their residences, despite the homeowners being current on mortgage payments. It had sent out 218 "acceleration" notices that homeowners were technically in default and must take action or risk foreclosure.[12]

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[10] Bond counsel issues the legal opinion accompanying a bond issue that the issue is valid and enforceable and that the interest on the bond is exempt from federal and state income tax. See California Debt and Investment Advisory Commission, *California Debt Issuance Primer*, Chapter 1, pp.4-5, available online at http://www.treasurer.ca.gov/cdiac/debtpubs/primer/chapter1a.pdf. CalHFA apparently views the opinion of Hawkins, Delafield & Wood as applying only to loans made with funds derived from the bond issue for which it rendered an opinion. See January 5, 2012, Senate Transportation & Housing Committee Bill Analysis of SB 477 (hereafter "SB 477 Bill Analysis"), available online at http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml;jsessionid=5146cf6a3e4deb0ae24c682d5030.

[11] *Good Deeds Punished: State-Run Mortgage Lender Forecloses on Californians Current on Their Loans* (hereafter "*Good Deeds*"), prepared by John Hill, California Senate Office of Oversight and Outcomes (Oct. 24, 2011) at pp. 1, 2.

[12] *Good Deeds* at pp. 1-2.

CalHFA issued negative credit reports even through homeowners were not delinquent on their payments. This leaves the homeowner with one of three choices: 1) move back into the residence; 2) sell the home at a substantial loss; or 3) allow CalHFA to foreclose. The first option is often impossible, since the residence may be the subject of a written lease and without renting the property the borrower would be unable to continue making mortgage payments. The second and third options will normally result in CalHFA suffering an uninsured loss as a result of the foreclosure.[13] It will destroy the homeowner's credit and impair the homeowner's ability to purchase another home. To date CalHFA continues to foreclose against borrowers with no hardship exception based solely on nonmonetary default of renting out of the residence.

Two examples of the hardships forced upon homeowners due to CalHFA's policy were discussed in *Good Deeds*. The most widely publicized case involves Marcia Wold, a Mountain View school teacher who purchased a 724-square foot condo in Sunnyvale with a CalHFA loan. She made it her home. She subsequently married a man with a young son. Her condo was too small for them to live in. She moved into the house that her husband co-owns with his parents. Because she could not sell her condo in the current market, she rented it out so she could help make the mortgage payments. Even with the rental of her condo, she was losing $1,000 each month. Nonetheless, she decided to keep paying her mortgage until she could sell or refinance. When CalHFA discovered that she was renting, it foreclosed on the condo.

This was only the most obvious hardship caused by CalHFA's policy. Consistent with its determination that rental of a residence is a default, CalHFA reports the default to credit reporting agencies. In Ms. Wold's case, CalHFA denied her request to forego reporting the technical default to credit reporting agencies. Her credit rating dropped from 802 to 679. This has made it difficult for her and her husband to refinance the Los Gatos house where they now live.

Dan, an active duty member of the Navy, was in a similar situation to Ms. Wold. At the time he was interviewed for *Good Deeds*, Dan was headed for foreclosure because he rented out his 820-square-foot condo at a loss after getting married and having a child. He said "I think it's a horrible program. It's almost like predatory lending. You expect something like that from Countrywide, but not from (an entity) with the name California in the title."

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[13] CalHFA's average uninsured loss on foreclosure was $38,000. Due to the depletion of insurance funds, each new foreclosure now costs the agency more than $50,000. *Good Deeds* at p. 3.

Another horror story was posted on January 26, 2011, on the LoanSafe.org website by a person using the name "whycalhfawhy". Her posting[14] tells a story similar to Ms. Wold's:

> Secured a loan thru CalHFA in 2006 for a condo in Sacramento county. OK interest rate, nice location, everything was fine. The purchase price was $300,000, we put down 20%, and we were happy making our payments through the tough years. Our family grew and we had 5 people occupying that 1,100 sqft 2 bedroom condo. With 1 more member joining our family we had to move. In December 2010 we purchased a home and rented out the condo. Even though we had to pay additional $500 every month to make up for the difference between the sub-market rental income and the mortgage by tapping into our savings we were doing it (it's negative cash flow of us ever since). Payments to CalHFA were never late and when we could we actually paid more (average about $1000 more in payment per year). We were so willing to do this while the condo was so worthless. In today's market it's worth only $180,000. That's just the "worth" on paper. If we try to sell it for that price, there will be 0 demand. In other words, the condo is a big liability to us and no one will pay for it unless we literally give it away for free. But, we were happy keeping that sinking ship on our books.
>
> Once we moved we called CalHFA to change our address on record. Guess what? They were very unhappy to find out that the condo is now a rental. We apparently violated the contract. We apologized (because honestly we really didn't know). The lady who helped us on the phone sent us a signed letter on Jan 13, 2011 with 2 options:
>
> 1. Pay all balance of $230,000 in 30 days, OR
>
> 2. Move back in the condo to make it our primary residence again
>
> Stunned with options given, we cried and then laughed, hysterically. We mailed her a letter on Jan 17 indicating our dilemma and asked for 1 year extension so we could try to gather all the funds together to pay the entire mortgage. In the meantime, we would continue payments just like before. We could not refinance the condo because it will cost us $90,000 to even get any lender to want to talk to us! And we don't have that kind of money

[14] Her posting is at http://www.loansafe.org/forum/deed-lieu-foreclosure-do-you-need-help-walk-away/37781-calhfa-pushing-us-default-think-you-heard-all-you-havent-heard-nothing-yet.html.

> unless we raid our 401k accounts. Thinking all this kinda made sense, we felt relieved and confident that she would be ok with it...
>
> How naive were we... on Jan 20 we got a letter with a big rejection. (Do you think she even read what we wrote given how fast we got her mail back?) Same options apply: Pay up or move back in.
>
> Supposedly our next mortgage payment is Feb 1. But because she accelerated our note there is no more next payment. Our next payment should be a check of $230,000. We have no option but to skip because WE CANNOT PAY!
>
> We are just so upset and so torn while posting this. We don't understand how we have to ruin our perfectly good credit and relationship just because the economic climate changed. Yes we shouldn't have rented out the condo but we did. If the condo was not so upside down we would try to refinance it by putting in more money. But that is just not the case! We were more than willing to pretend the condo was still worth $300,000 and acted the part. Why not let us? CalHFA knows perfectly well that we don't have that kind of $$! Why provide those options when they know it's just outright ridiculous! They don't want us to pay anymore. They want to take the condo back from us.

Several individuals who posted replies to whycalhfawhy's posting claimed to be in a similar situation.

CalHFA has created a policy that makes the housing situation worse for the very people CalHFA was intended to help. CalHFA is wasting valuable taxpayer dollars as well as the time and energy of its customers. A review of one homeowner's deed of trust reveals that nowhere in the terms of the deed of trust nor in the promissory note is there language that prohibits the condominium from being rented. The promissory note states, in relevant part:

> Borrower further understands that the Agency and the Tax Code require that borrowers of funds originated by the sale of said tax exempt municipal securities, and the property securing said loans, meet certain specific criteria, including but not limited to, **intent to occupy the Property as his/her principal place of residence during the term of this Note.**

All other CalHFA riders regarding occupancy reference the rights of lender pursuant to the terms of the promissory note and the deed of trust. The covenant to occupy the property during the life of the loan is clearly based on the borrower's *intent* to occupy the property at the time the parties entered into the note obligation. CalHFA has no contractual rights to foreclose on the condominium if life circumstances change subsequent thereto, causing the owner to move out and rent the property in order to service the debt. It does not appear that anybody has pointed this out to CalHFA. CalFHA has foreclosed on a number of owners under its policy that rental is a default, regardless of the owner being current on mortgage payments. These foreclosures appear to be improper and illegal because CalHFA did not have the contractual right to foreclose on this basis.

Nevada and Georgia are the only two states that interpret the residence requirements of section 143 in a manner similar to that of CalHFA, although they allow rental if the homeowner is on military deployment. Like CalHFA, Nevada uses Orrick Harrington & Sutcliffe as its outside bond counsel. While having the same policy as California, Georgia has not foreclosed on homeowners who rent due to a change of circumstances.

Several states, such as Minnesota, Ohio, Utah, Virginia and Washington, allow rental for any reason, while others, including Florida and New Jersey, allow rental in hardship cases.[15]

In August, 2010, in response to requests by homeowners to be allowed to rent out their homes due to the collapse of the housing market, CalHFA adopted a policy under which a homeowner can rent his residence for up to one year without being in default if he could document an involuntary financial hardship due to one of four circumstances:

a. Reduced income resulting from reduced hours, pay cuts, or a new job.

b. An involuntary increase in living expenses or medical costs.

c. An involuntary job transfer, including military assignment, with a possible return in one year.

d. Being forced to look for a job outside the area with the possibility of returning, selling or refinancing the home within one year.

[15] *Good Deeds* at pp. 14-18.

If a borrower could document one or more of these financial hardships, and CalHFA granted a waiver, the mortgagor could rent out the home for one year and seek month-to-month extensions. Under this policy, rental exceptions were not to exceed five percent of the loans outstanding under the relevant bond issue. This policy did not apply to mortgagors who moved from a CalHFA financed home due to a "voluntary" change of circumstance, such as marriage, having children, or getting a new job. Nor did it apply to a long-term job transfer, including a military posting. The policy did not grant homeowners automatic rights. CalHFA had complete discretion to foreclose or grant the short term waiver.

Due to concerns that CalHFA's policy was too harsh and was punishing homeowners who were attempting to live up to their commitments, in early 2011 Senator Mark DeSaulnier introduced SB 477. The bill would have prohibited CalHFA from foreclosing on a homeowner for renting out his residence if the following conditions were met[16]:

a. The borrower is current on mortgage payments and has not violated any term of the loan except the rental prohibition.

b. The borrower lived in the home for one year or more after obtaining the mortgage.

c. No more than 4% of the proceeds of the relevant bond issue are for homes that are being rented.

On February 3, 2012, CalHFA issued Program Bulletin 2012-01, which set out a new policy on rentals.[17] The new policy requires homeowners in this situation to submit substantial documentation to CalHFA for an underwriter to review. Under its new policy, CalHFA announced that it would allow, within its discretion, a homeowner to rent his home if a number of conditions were all met:

1. The borrower had a reasonable expectation that the home would be his principal residence at loan origination.

2. The current loan balance in relation to the home's current market value prevents the Borrower from either selling the home or refinancing the loan.

3. The homeowner is current on the mortgage.

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[16] See S.B. 477 Bill Analysis.

[17] Program Bulletin 2012-10 is available online at http://www.calhfa.ca.gov/homeownership/bulletins/2012/2012-01.pdf.

4. The homeowner lived in the home for at least one year after obtaining a mortgage.

5. The homeowner demonstrates that he can meet the obligations of both the new housing expense and the pre-existing CalHFA mortgage payment.

6. The homeowner must provide a complete list of all real property that he or she owns and copies of deeds upon request.

7. The homeowner signs an affidavit stating that, when feasible, he or she i) will reoccupy the CalHFA-financed property as a primary residence, ii) will sell the property or iii) will retire the CalHFA loan with replacement financing and iv) that property was not purchased for investment purposes.

8. The homeowner is required to complete and sign a "Consent to Rent Agreement" which grants CalHFA a security interest and assignment of the entire amount rental payments received and submit a copy of the an existing rental agreement.

9. Homeowner is required to provide CalHFA with most recent two years of Form 1040 Federal Tax Returns.

10. Homeowner is required to pay the actual cost of a Broker's Price Opinion or valuation of the subject property.

11. Homeowner is required to complete a financial questionnaire, submit paystubs, rental payments

If the homeowner is successful in obtaining the waiver, CalHFA permits him or her to rent the residence for an initial period of 12-months, beginning on the date the tenant signed a rental agreement. So if the tenant signed a rental agreement with the homeowner 11-months before CalHFA approves the waiver, CalHFA will permit the property to be rented for one month, even if it took CalHFA 7-months to approve the waiver request. The homeowner is required to submit extensive documentation to verify that he or she can meet the obligations of both the new housing expense and the pre-existing CalHFA mortgage payment. This requirement did not exist under the old policy. For many people suffering financial hardship, including job loss or relocation, this new requirement may be difficult, making the new policy even worse than the prior policy in this sense.

Despite its announced policy, CalHFA has been conservative in exercising its discretion to allow homeowners to rent their residences during the term of the loan. CalHFA waiver requests are taking three times as long under the current policy as compared to the prior policy. The approval period takes longer due to all the burdensome financial paperwork that homeowner's are now required to submit. CalHFA is granting much shorter rental periods than the prior policy. In one recent case, it took 9 months to process the rental request, and in the end, CalHFA only approved the property to be rented for 1 month. This means that after 9 months of seeking the waiver the homeowner had to redo the entire process just 1 month later. The current policy has turned out to be more punitive than the prior policy.

The public has expressed serious concerns with the current CalHFA policy. At the Board of Director's meeting in January 2012, Katharine Jordan, a CalHFA mortgage holder, discussed her plight with CalHFA's policy.[18] She lives in Sacramento and obtained a CalHFA loan to purchase her principal residence at that time. She is visually impaired. At the time of purchase, the property was perfect for her because it was close to public transportation and she could walk to the grocery school and work. However, her life changed dramatically when her father passed away and she had to take care of her family. Her mother moved into the condo with her but the stairs in the condo were too dangerous for her mother. She fell down the stairs just three days after she had moved in and suffered a severe concussion. The condo was no longer safe for her and her family. She had to move out, but continued to pay the mortgage. However, she cannot physically move back in, which is one of the requirements under the current policy when it becomes feasible.

The legislature needs to fix this problem because CalHFA cannot. CalHFA continues to threaten homeowners who have legitimate hardships and are current on the mortgages with foreclosure and the downgrading of their credit.

B. Other Adverse Effects of CalHFA's Policy on Rental of CalHFA Financed Residences

Besides foreclosure, CalHFA's policy regarding the rental of CalHFA-financed residences can cause other problems for borrowers who are current on their payments and not in default of either the terms of the note or the deed of trust encumbering the property. CalHFA's policy of issuing negative credit reports on

[18] The minutes are available online at http://www.calhfa.ca.gov/about/events/board-meetings/books/2012/Book299-2012-03-14/Book299_ApprovedMinutes2012-01-19.pdf.

such borrowers causes their credit scores to drop precipitously. They have a difficult time obtaining additional credit, have to pay higher interest rates when they do obtain new lines of credit and find that the interest rates on their credit cards have been raised while the credit limits have been lowered. This makes it even more difficult for people to purchase a home.

If the borrower obtained a second on the residence, foreclosure will put them in default of the terms of the second and accelerate the note, so that the entire amount becomes due immediately.

The policy can also have a negative effect on the foreclosed homeowner's tax situation. Tax-exempt home mortgage bonds are in effect a subsidy because they allow the borrower to obtain financing at rates that are, at the time of financing, below market. Under Internal Revenue Code section 143(m), this subsidy is recaptured if the financed residence is disposed of within nine years of purchase. The recapture is accomplished by means of a "recapture tax." The recapture tax is levied on the mortgagor as part of his or her individual tax liability and does not affect the tax-exempt status of the bonds. The tax is 1.25% of the loan amount for each year, up to 6.25%. For a disposition that occurs more from 6 to 9 years after acquisition, the tax is phased out. The maximum tax is limited to no more than 50% of the gain from the sale or other disposition of the property.

A lender whose loan is secured by a second trust deed on a CalHFA-financed residence that is foreclosed may write off the unpaid balance of the note. This will result in a loss to the second trust deed and in "cancellation of debt" income to the borrower under IRC section 61, unless the borrower comes within one of the exceptions contained in IRC section 108.

C. The Internal Revenue Code Provisions on Tax Exempt Housing Bonds

State Legislature should adopt legislation that would require CalHFA to apply section 143 of the Internal Revenue Code in the same manner as 47 of its 49 sister states, thereby allowing homeowners current on their mortgages with CalHFA to avoid foreclosure and reducing losses to CalHFA resulting from its own actions. Internal Revenue Code section 103(a) exempts from gross income interest on any State or local bond. This exemption does not apply to "any private activity bond which is not a qualified bond (within the meaning of section 141)."[19] A private activity bond is a bond whose proceeds are used to finance a

[19] Internal Revenue Code Section 103(b)(1).

nongovernmental trade or business or to make a private loan.[20] One type of private activity bond that is a qualified bond is a "qualified mortgage bond" under Internal Revenue Code section 143.[21]

The qualified mortgage bond provisions of section 143 are derived from former section 103A, which was enacted as part of the Mortgage Subsidy Bond Tax Act of 1980. The purpose of the Act was to direct the "subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the total revenue loss from the use of tax-exempt bonds for housing."[22] Under the Act, a bond issued to provide funding for mortgages for owner-occupied residences was not tax exempt unless the bond was a "qualified mortgage bond."[23]

Interest paid on a "qualified mortgage bond" by a state or local governmental agency is exempt from income tax.[24] Many of the provisions of section 103A are contained in present section 143. Under section 143, to be a "qualified mortgage bond" a bond must meet several requirements, two of which are relevant to the issue of whether rental of a residence jeopardizes a bond's exempt status. First is the requirement that a residence purchased with bond funds must be a single-family residence "which can reasonably be expected to become the principal residence of the mortgagor within a reasonable time after the financing is provided."[25] Second, the bond issue must not meet the private business use tests of Internal Revenue Code section 141(b)(1) and (2),[26] which provide:

> (1) Private business use test. -- Except as otherwise provided in this subsection, an issue meets the test of this paragraph if more than 10 percent of the proceeds of the issue are to be used for any private business use.
>
> (2) Private security or payment test.— Except as otherwise provided in this subsection, an issue meets the test of this paragraph if the payment of the principal of, or the interest on, more than 10

[20] Internal Revenue Code section 141(a).
[21] Internal Revenue Code section 141(e)(1)(B).
[22] H. R. Conference Rpt. No. 96-1479, 96th Cong. 2nd Sess. at 171 (1980), reprinted at 1980-2 Cum. Bull. 530, 576.
[23] *Id.*
[24] Treas. Reg. (26 C.F.R.) secs. 6a.103A-1(a)(1),(2), 6a.103A-2(a).
[25] Internal Revenue Code (26 U.S.C.) section 143(a)(2)(A)(ii), section 143 (c)(1).
[26] Internal Revenue Code (26 U.S.C.) section 143(a)(2)(A)(iii).

percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly—

(A) secured by any interest in—

(i) property used or to be used for a private business use, or

(ii) payments in respect of such property, or

(B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

The agency issuing the bonds must make a good faith effort to meet the residency and certain other requirements.[27] The good faith requirement is met if

(i) the issuer in good faith attempted to meet the requirements before the mortgages were executed,

(ii) 95 percent or more of the proceeds devoted to owner-financing was devoted to residences with respect to which (at the time the mortgages were executed) all the requirements were met, and

(iii) any failure to meet the requirements is corrected within a reasonable period after the failure is first discovered.[28]

The purpose of section 143 is to ensure that the tax subsidy provided by the exemption assists individuals of low- and moderate-income to purchase a principal residence. One interpretation would be that if a borrower moves from a residence purchased with funds from a qualified bond issue, without intending to move back, the funds are not being used for the purpose for which the exemption is granted.

There are a number of compelling factors, however, that support the interpretation that the residence requirement of section 143 is met if the mortgagor intended the home to be his residence at the time the loan was funded and that, therefore, the subsequent rental of the residence should not jeopardize the bond issue's exemption. First, the statute states that the residence requirement is met if the financed home "can reasonably be expected to become the principal residence of the mortgagor within a reasonable time after the financing is provided."[29]

[27] Internal Revenue Code (26 U.S.C.) section 143(a)(2)(B).
[28] Internal Revenue Code (26 U.S.C.) section 143(c).
[29] Section 143(c)(1)(A).

Additionally, section 143(a)(2)(B)(i) states that the residence requirement is met if the issuer of the bond "in good faith" attempted to meet the requirement before the mortgage was funded, while section 143(a)(2)(B)(iii) states that the requirement is met if any failure to meet it "is corrected within a reasonable period after such failure is first discovered." These provisions indicate that the residency requirement is determined by the mortgagor's intent at the time the loan has been made. That the mortgagor subsequently obtains a different principal residence is irrelevant, so long as his or her intent was to make the CalHFA-financed home his principal residence at the time the loan was obtained.

Both the Legislative History and the Treasury Regulations concerning the qualified mortgage bond provisions emphasize that the test of whether a residence meets the requirements is made at the time that the mortgage is funded and is based on "reasonable expectations." Thus, the House Ways and Means Committee Summary of section 103A states that:

> All mortgages must be for single-family residences that **can reasonably be expected** to become the principal residences of the mortgagors.[30]

(Emphasis added.)

The Internal Revenue Service issued regulations under section 103A, but not under section 143. Nonetheless, given the virtually identical language concerning the residency requirement of section 103A and section 143, those regulations provide guidance as to the proper interpretation of that requirement.

Treas. Reg. section 6a.103A-2(d)(2) provides that an issuing agency will usually meet the residence requirement if the mortgagor executes an affidavit stating that he intends to use the residence as his principal residence within 60 days of funding. Additionally, the following example of compliance with the residence requirement contained in the regulations indicates that rental does not violate the residency requirement:

> A contracts to purchase a new residence from B. Since B is unable to move from the residence until 1 month after the scheduled closing date, A agrees to lease the residence to B for 1 month at a rent equal to the fair rental value. A applies for a mortgage to be provided from the proceeds of a qualified mortgage bond. In light of all the facts and circumstances in the case, the fact that A temporarily leases the residence to B does not prevent the

[30] 1980-2 Cum. Bulletin at 531.

residence from being considered as property that can reasonably be expected to be used as A's principal residence within a reasonable period of time after financing is provided.[31]

Since these regulations are not inconsistent with the language of the statute, and are reasonable interpretations of the statute, they have the force and effect of law.[32]

Other than the regulations under section 103A, the IRS has not issued any other "formal guidance" concerning the interpretation of section 143 in general or the residency requirement in particular. The Internal Revenue Service's only informal guidance on this issue is found in Module F, Section 143 – Qualified Mortgage Bonds, course for tax exempt bonds.[33] This Module states that whether the residence requirement is met is determined by the reasonable expectations of the issuing agency at the time the loan is made. The module goes on to state that a residence acquired for use in a trade or business or for investment purposes will not qualify.[34] While the IRS considers regulations, revenue rulings, revenue procedures and judicial opinions to have precedential value, "informal guidance," such as FAQs and its own manuals, are not considered to be precedent, so that a taxpayer cannot rely on them.[35]

The statute, Treasury Regulations, the legislative history and the Internal Revenue Service's informal pronouncements do not support an interpretation of the residency requirement as prohibiting the rental of the home during the life of the loan. Thus, CalHFA's apparent belief that the residency requirement is violated by rental of the home is not supported.

While subsequent rental of the residence does not violate the residency requirement, as long as the mortgagor had the requisite intent when the loan was made, an argument could be made that it violates the "private business use" provisions of section 141(b)(1) and (2). The private business use provisions of section 141(b)(1) and (2) are met if more than 10 percent of the proceeds of a

[31] Treas. Reg. §6a.103A-2(d)(5), Example 1.
[32] In *Mayo Foundation v. United States*, 562 U.S. ___ (2011), the Supreme Court held that Treasury Regulations issued under the Internal Revenue Code are entitled to *Chevron* deference. Under *Chevron v. Natural Resources Defence Council*, an administrative agency's regulation is entitled to deference if a) the statute under which it was issued is either ambiguous or does not directly address the issue and b) the agency's construction of the statute is "permissible." *Mayo Foundation* is available online at http://www.supremecourt.gov/opinions/10pdf/09-837.pdf.
[33] Available online at http://www.irs.gov/pub/irs-tege/teb_phase_1_course_11204_-7module_f.pdf.
[34] *Id.* at p. 4.
[35] Treas. Reg. §1.6662-4(d)(iii) lists the types of authority that a taxpayer can rely on to support a position. While court cases, regulations, IRS rulings and legislative history are included, "informal" pronouncements of the IRS, such as the Internal Revenue Manual, FAQs, and similar pronouncements are not considered authority.

bond issue are used in a trade of business of a non-governmental person.[36] A private business use is defined as direct or indirect use of the property in a trade or business carried on by any person other than a governmental unit.[37]

The regulations issued under section 141 state that "the lease of financed property to a nongovernmental person is a private business use of that property."[38] Similarly, in *Hazard v. Commissioner*,[39] the Tax Court held that a taxpayer's rental of a property was a business activity, even though the taxpayer had only one rental unit. While the regulation exempts the rental of financed property for a limited duration, typically not more than 100 days, this would not apply to most of the homeowners who are renting financed homes because they cannot either sell or refinance them.

Despite such rentals constituting "private business use," allowing homeowners who due to a change of circumstances are required to rent the home would not run afoul of the prohibition on private business use. This is because the prohibition on private business use is only violated if more than 10% or the proceeds of a bond issue are being used in a private trade or business. If 10% or fewer of the homes financed by a bond issue are being rented at any one time, the private use prohibition is not violated. CalHFA would be in compliance with the private business use tests if it limits the rental of homes to those purchased with not more than 10% of the proceeds of the bond issue.

D. The Legislature Should Enact Legislation Requiring CalHFA to Allow Rentals of Residences That the Mortgagor Intended to Use as a Principal Residence

CalHFA's policy is not required by the Internal Revenue Code provisions under which home-mortgage bonds are granted tax exempt status. If the borrower intended to use the financed property as the principal residence when the loan was obtained, the residence requirement of IRC section 143 is met. CalHFA's program bulletins that "liberalized" its policy and allow borrowers under certain circumstances to rent their homes is cumbersome, slow and frequently results in CalHFA declaring a person seeking a waiver in default and foreclosing on the home.

[36] Internal Revenue Code section 141(b)(1).
[37] Internal Revenue Code section 141(b)(6)(a).
[38] Treas. Reg. §1.141-3(a)(3).
[39] 7 TC 742 (1970).

Because of CalHFA's reluctance to adopt a realistic rental policy that would bring it in line with the policies of a majority of California's sister states, legislation is needed. We therefore would propose the enactment of legislation similar to the legislation previously proposed by Senator DeSaulnier. The legislation would enact new sections to the Health & Safety Code provisions concerning the CalHFA. The legislation should have the following provisions.

1. A borrower whose property is being financed by a CalHFA loan would be able to rent the residence without any prior showing of need, as long as the borrower has used the property as his or her principal residence for at least 12 consecutive months. The 12 month period would start when the borrower moves in to the property, but no later than 60 days after escrow is closed on the property and the CalHFA loan is funded.

Since all that is required by the Internal Revenue Code for a bond issue to be tax exempt is that loan proceeds to be used to purchase a property that the borrower intends to use as his or her principal residence, requiring a borrower to live at the property for a minimum of 12 months would provide objective evidence that of the borrower's intent. Because the Internal Revenue Code does not prohibit a borrower from renting out the residence, there is no reason for CalHFA to condition rental on its discretion or upon the borrower establishing the existence of certain conditions beyond meeting the requirement that the property was purchased with the intent to use it as a principal residence.

2. CalHFA may not declare a borrower in default solely because he or she is renting the residence, so long as the borrower resided there for the 12 month period. CalHFA must accept any payment tendered by a borrower who began renting the residence after the requisite 12 month period and apply that payment to the loan. CalHFA may not issue a negative credit report on a borrower who is current on payments merely because the borrower is renting the property.

This will ensure that CalHFA does not create a default by not applying loan payments made by borrowers who are renting their properties, thereby causing a negative credit report on the borrower to be sent to credit-reporting agencies. These reports have caused substantial financial and emotional harm to borrowers who are renting their property, even if CalHFA does not foreclose and ultimately grants a waiver.

3. CalHFA will take steps to remove any negative credit report issued on a borrower who was current on sending in payments but was deemed to be in default because the residence was being rented.

This will alleviate some of the damage done to borrowers whose credit was impaired due to CalHFA's negative credit reports. What is most worrisome is that many of the borrowers about whom CalHFA issued negative credit reports because they were renting the residence is that the borrowers were not in default under the terms of the note and the deed of trust. The borrower merely had to verify that he/she intended to occupy the property as the principal residence during the term of the note.

4. If 7% of the proceeds of the relevant bond issue are for homes that are being rented, CalHFA may require any future rentals of homes funded by that bond issue upon obtaining a waiver, with the borrower being required to show an objective need, including change of circumstances due to a new job, marriage or children. Any waiver is not to be limited to a specified time period, such as 12 months. So that CalHFA can know the extent to which homes funded by a specific bond are being rented, a borrower who rents property will have to give CalHFA written notice that the property is being rented and the borrower's new principal residential address.

Under the Internal Revenue Code provisions concerning business usage, proceeds of a bond issue are in compliance with this provision if not more than 10% of the proceeds are used for private business usage. If rentals by borrowers is a "private business use," this provision will ensure that CalHFA is notified well before the 10% level is reached, so it can take steps to ensure that the exempt status of the bond issue is not jeopardized.

5. All notices of default, notices of expiration of waiver and similar notices will be sent by CalHFA to the borrower by U.S. Mail addressed to the borrower's last known address in the files of CalHFA. CalHFA may not use email to contact a borrower unless the borrower has given express written consent to be contacted by email.

This provision will ensure that CalHFA gives appropriate notice to a borrower, especially if it deems a borrower in default. It will also ensure that CalHFA does not use email to transmit potentially sensitive information by email without the written consent of the borrower.

6. CalHFA will automatically remove Private Mortgage Insurance on a borrower's residence if the borrower has paid 78% of the original value of the property securing the loan, provided the borrower is current on mortgage payments. CalHFA may not continue to refuse to cancel Private Mortgage Insurance on the grounds that the property is no longer homeowner occupied or because it refused to apply a payment because the borrower was renting the property.

This will bring CalHFA into compliance with the federal Homeowners Protection Act of 1998, which prohibits a lender from requiring a homeowner to continue paying for mortgage insurance if the homeowner has paid down the mortgage to 78% of the original value of the property securing the loan.[40] CalHFA is not in compliance with federal laws, which preempt its current policies regarding private mortgage insurance.

E. Conclusion.

CalHFA has been operating in violation of its primary statutorily mandated purpose. It was created to meet the housing needs of low and moderate income persons and families by reducing the costs of mortgage financing to make homeownership more feasible. Instead it has implemented a system that has done just the opposite. Each time CalHFA forecloses or threatens to foreclose on a homeowner who is current on his/her mortgage payments it increases the costs of mortgage financing and makes homeownership less feasible. CalHFA has been destroying the credit of the very individuals that it was intended to assist even though these individuals remain current on their mortgages.

If an owner has to move out from a CalHFA financed residence due to changes in circumstances and rents the property because it cannot be refinanced or sold for an amount sufficient to cover the debt on the property, CalHFA should not punish that person by holding him/her in default and, potentially, foreclosing on the residence. The California Legislature needs to stop CalHFA's actions, which have caused serious harm to the very persons CalHFA was formed to help. CalHFA has one of the lowest customer service ratings out of all California agencies. CalHFA should not make these difficult economic times more difficult for low and moderate income families who are current on their mortgage

[40] 12 U.S.C. section 4902.

obligations by foreclosing or threatening to foreclose because the residence is being rented. CalHFA has proven that it cannot resolve this problem on its own. For these reasons, the authors of the paper submit that the Legislature should enact the suggested (or similar) legislation in order to help improve the situation for these California residents and to bring CalHFA's policies in compliance with federal laws and in line with those of the overwhelming majority of California's sister states.