Lesson 8

Section 143 – Qualified Mortgage Bonds

Overview

Introduction

In Phase I, Lesson 4, you learned about the private activity bond tests, including the consumer loan test. Lesson 4 of Phase II discussed the various types of exempt facility bonds, which are private activity bonds because they satisfy the private business use test. This lesson will cover a type of qualified private activity bond – qualified mortgage bonds – that are private activity bonds because they satisfy the private loan financing test.

Objectives

At the end of this lesson, you will be able to:

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

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Contents

This lesson contains the following topics:

Sources of Law

Statutory Provisions

Section 143 provides the requirements for qualified mortgage bonds.

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

Regulations

Regulations. §1.103A-2, §§6a.103A-1, -2 and -3, and §1.143(g)-1 provide rules for qualified mortgage bonds. It is important to note that, except for §1.143(g)-1, these regulations were issued before the 1986 Act for guidance under §103A of the 1954 Code. The older regulations still apply, but must be read with the statutory changes in mind.

General Rules

Definition of Qualified Mortgage Bond

To be a qualified private activity bond, a bond used to finance mortgages must be issued as part of a qualified mortgage issue.

Under §143(a)(2), to be a qualified mortgage issue:

- the proceeds of the issue must be used to finance (but not refinance) owner-occupied residences
- the residences must meet the "principal residence" and "purchase price" requirements
- the owner must meet the "first-time homebuyer" and "income" requirements
- the issuer must meet the "targeted area" requirement and must provide the owners with notification of the "recapture tax," **and**
- the issue must meet special expenditure and redemption requirements and special arbitrage rules, and must not meet the private business use and private security or payment tests under § 141(b)

Use of Lendable Proceeds

The issuer must reasonably expect to use all (100%) of the proceeds to finance owner-occupied residences, except for amounts used to pay issuance costs or to fund a reasonably required reserve. The proceeds available to make mortgages after payment of issuance costs and funding of a reasonable reserve are referred to as the "lendable proceeds."

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Good Faith Effort

A bond issue that fails to meet one or more of the principal residence, purchase price, first-time homebuyer, income and "no refinancing" requirements may still be treated as meeting such requirements if –

- the issuer in good faith attempted to meet all those requirements before the mortgages were executed,
- 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 those requirements were met, **and**
- any failure to meet those requirements is corrected within a reasonable time after the failure is discovered.

A bond issue that fails to meet one or more of the targeted area, recapture tax notice and arbitrage requirements may still be treated as meeting such requirements if –

- the issuer in good faith attempted to meet all those, **and**
- any failure to meet those requirements is due to inadvertent error after the issuer took reasonable steps to comply with the requirements

Note

There is no good faith cure provision for the failure to meet the special expenditure and redemption requirements or if the issue meets the §141(b) private business test.

Principal Residence

Residence Requirement

Section 143(c) provides that:

- each mortgage loan must be made to finance a single family residence that is reasonably expected, at the time of the making of the loan, to be used as the mortgagor's principal residence, **and**
- the property financed with the proceeds of the bonds must be located in the jurisdiction of the issuer

Note

Reasonable expectations as to meeting the principal residency requirement are often met by the mortgagor's execution of an affidavit. Regulations §6a.103A-2(d)(2).

Principal Residence

Under Regulations §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.
- Excess land that provides, more than incidentally, a source of income, may not be financed as part of the residence." See *Examples (2) and (3)* under Regulations §6a.103A-2(d)(5).

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Principal Residence, Continued

Single Family Residence Requirement

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 (*i.e.*, no new construction)

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

Three-Year Requirement

General Rule

Under §143(d)(1), at least 95 percent of the net proceeds of the issue must be loaned to mortgagors that did 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. See Regulations §6a.103A-2(e) for more information.

Exceptions 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
- Refinancing of a contract for deed with respect to land and financing the construction of any residence on it. This concept is discussed more thoroughly in the "New Mortgage Requirement" portion later in this lesson.

"Qualified home improvement loans" are loans that finance alterations, repairs and improvement on or in connection with an existing residence when such alterations, repairs and improvement substantially protect or improve the basic livability or energy efficiency of the property. The loans are limited to $15,000. This amount, first enacted in 1981, is not indexed for inflation.

Qualified rehabilitation loans are discussed in more detail in the New Mortgage Requirement portion of this lesson.

Multiple Mortgagors

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

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

However, when 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.

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Three-Year Requirement, Continued

Ownership Interests

Regulations §6a.103A-2(e) differentiates between interests in real estate that constitute ownership interests and interests that do not, as follows:

OWNERSHIP INTERESTS	NOT OWNERSHIP INTERESTS
• fee simple • joint tenancy • tenancy in common • tenancy by the entirety • tenant-shareholder in a cooperative • life estate • land contract	• remainder interest • lease (with or without an option to purchase) • expectancy to inherit • interest under a purchase contract • interest in other than a principal residence (*e.g.*, rental property investment)

Targeted Area Requirement

General Rule

Under § 143(h)(1), at least 20 percent of the proceeds of the issue that are to be used for mortgage financing must be made available (with reasonable diligence) for financing of targeted area residences for at least one year after the date mortgage financing is first made available in targeted areas.

Limit on Requirement

The 20 percent amount may be reduced to an amount equal to 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding three calendar years for single-family, owner-occupied residences located in the targeted areas within the issuer's jurisdiction.

Definitions

The term "targeted area residence" means a residence in an area which is either:

- a qualified census tract, or
- an area of chronic economic distress.

The term "qualified census tract" means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income. The determination of whether a census tract is qualified is to be made on the basis of the most recent decennial census for which data are available.

The term "area of chronic economic distress" is defined in § 143(j)(3).

Purchase Price Limitations

General Rule

Under § 143(e), the "acquisition cost" of a residence must not exceed 90 percent of the "average area purchase price." This is the average purchase price for all single-family residential sales in the same "statistical area" as the financed property during the last 12 months for which sufficient statistical information is available. The determination is to be made as of the date of the commitment to finance the mortgage or, if earlier, the date the residence was purchased.

Special Rules and Definitions

Under §143(e)(5)**,** for a targeted area residence, the purchase price limit is 110 percent of the average area purchase price**.**

Under §143(e)(3) and (e)(4)**,** the average area purchase price is to be calculated separately with respect to new and previously occupied residences, and for one, two, three, and four-family residences. But published guidance is typically relied upon by issuers. See below.

The "statistical area" is the metropolitan statistical area (MSA). If the property is not in a metropolitan statistical area, the "statistical area" is the county (or portion of the county outside the MSA) in which the property is located. For Louisiana, "county" means "parish." Alaska is treated as one county.

Depending on the state and location, counties may contain a large or a small number of transactions during the prior 12 months. If there is insufficient recent statistical information with respect to a county (or portion of a county), the issuer may ask the Commissioner to designate another area as the statistical area.

"Acquisition cost" includes all amounts paid in cash or in kind by the buyer (or a related party) to the seller (or a related party), plus the cost of completing an unfinished residence, whether or not such is paid with proceeds, plus, if the building is subject to ground rent, the capitalized value of the ground rent. Acquisition cost does not include usual settlement and financing costs. It does not include the value of services performed (sweat equity) by the mortgagor and his or her spouse, brothers and sisters, ancestors and lineal descendants. Acquisition cost does not include the cost of land owned by the mortgagor at least two years before construction begins on the residence.

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Purchase Price Limitations, Continued

Published Safe Harbor Guidance

Under Regulations §6a.103A-2(f)(5), an issuer may rely upon average area purchase price limitations published by the Treasury Department.

Issuers may use a higher limitation for an area covered by the Treasury Department publication if the issuer has more accurate and comprehensive data.

Until 1994, approximately annually, the Service published a revenue procedure containing safe harbor purchase price limitations based on estimates of the average area purchase price from the Department of Housing and Urban Development, which in turn were based on information from the "Mortgage Interest Rate Survey" prepared by the Federal Housing Finance Board. After 1994, for several years no guidance was published. In Rev. Proc. 2004-18, the Service published guidance based on FHA limits on the dollar value of loans. FHA sets an area's loan limit at 95 percent of the median home sales price for the area, subject to certain floors and caps measured against conforming loan limits. The Service has published safe harbor guidance annually in recent years.

Income Limitations

General Rules

Under §143(f), 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. The applicable median family income means the greater of

- the area median gross income for the area in which the residence is located, and
- the statewide median gross income for the State

Under § 143(f)(6), for "families" of one or two persons, the 115 percent limit becomes 100 percent of applicable median family income.

Family income and area median income are determined in accordance with Section 8 regulations under the Housing Act of 1937. HUD publishes data annually. See a page from the 2009 publication on the following page. The table indicates that the median income for the Portland-Vancouver-Beaverton MSA is $70,000.

Note

The Housing and Economic Recovery Act of 2008 (Public Law 110-289) modified the determination of the income limits used to determine qualification levels for projects funded with tax credits authorized under §42 and projects financed with exempt facility qualified residential rental projects, but did not change the determination of the income limits under §143(f) for qualified mortgage bonds.

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Special Rules

Under §143(f)(3), in case of any financing for targeted area residences:

- one-third of the mortgages may be provided without regard to the income limitation, **<u>and</u>**
- the income 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

Under §143(f)(6), for "families" of one or two persons, the 140 percent for targeted area residences becomes 120 percent of applicable median family income.

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Income Limitations, Continued

Adjustments

Section 143(f)(5) permits adjustments to the income limits for residences located in high cost housing areas. High cost housing areas are any statistical areas (see discussion under Purchase Price Limitations, above) where the "housing costs/ income ratio" is greater than 1.2. The formula for adjusting the income limit for high cost housing cost areas is set forth in §143(f)(5), and the adjusted limit cannot exceed 140 percent (120 percent for one and two person families) of the area median gross income.

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Income Limitations, Continued

HUD family income determinations

STATE: OREGON — I N C O M E L I M I T S

	PROGRAM	1 PERSON	2 PERSON	3 PERSON	4 PERSON	5 PERSON	6 PERSON	7 PERSON	8 PERSON
Bend, OR MSA									
FY 2009 MFI: 63500	30% OF MEDIAN	13350	15250	17150	19050	20550	22100	23600	25150
	VERY LOW INCOME	22250	25400	28600	31750	34300	36850	39350	41900
	LOW-INCOME	35550	40650	45700	50800	54850	58950	63000	67050
Corvallis, OR MSA									
FY 2009 MFI: 70800	30% OF MEDIAN	14900	17000	19150	21250	22950	24650	26350	28050
	VERY LOW INCOME	24800	28300	31850	35400	38250	41050	43900	46750
	LOW-INCOME	39650	45300	51000	56650	61200	65700	70250	74800
Eugene-Springfield, OR MSA									
FY 2009 MFI: 57200	30% OF MEDIAN	12000	13700	15450	17150	18500	19900	21250	22650
	VERY LOW INCOME	20000	22900	25750	28600	30900	33200	35450	37750
	LOW-INCOME	32050	36600	41200	45750	49400	53050	56750	60400
Medford, OR MSA									
FY 2009 MFI: 55400	30% OF MEDIAN	11600	13300	14950	16600	17950	19250	20600	21900
	VERY LOW INCOME	19400	22150	24950	27700	29900	32150	34350	36550
	LOW-INCOME	31000	35450	39850	44300	47850	51400	54950	58500
Portland-Vancouver-Beaverton, OR-WA MSA									
FY 2009 MFI: 70000	30% OF MEDIAN	14700	16800	18900	21000	22700	24350	26050	27700
	VERY LOW INCOME	24500	28000	31500	35000	37800	40600	43400	46200
	LOW-INCOME	39200	44800	50400	56000	60500	64950	69450	73900
Salem, OR MSA									
FY 2009 MFI: 58200	30% OF MEDIAN	12200	13950	15700	17450	18850	20250	21650	23050
	VERY LOW INCOME	20350	23300	26200	29100	31450	33750	36100	38400
	LOW-INCOME	32600	37250	41900	46550	50250	54000	57700	61450
Baker County, OR									
FY 2009 MFI: 45400	30% OF MEDIAN	10500	12000	13500	15000	16200	17400	18600	19800
	VERY LOW INCOME	17500	20000	22500	25000	27000	29000	31000	33000
	LOW-INCOME	28000	32000	36000	40000	43200	46400	49600	52800
Clatsop County, OR									
FY 2009 MFI: 55600	30% OF MEDIAN	11700	13350	15050	16700	18050	19350	20700	22050
	VERY LOW INCOME	19450	22250	25000	27800	30000	32250	34450	36700
	LOW-INCOME	31150	35600	40050	44500	48050	51600	55200	58750
Coos County, OR									
FY 2009 MFI: 48400	30% OF MEDIAN	10500	12000	13500	15000	16200	17400	18600	19800
	VERY LOW INCOME	17500	20000	22500	25000	27000	29000	31000	33000
	LOW-INCOME	28000	32000	36000	40000	43200	46400	49600	52800
Crook County, OR									
FY 2009 MFI: 51200	30% OF MEDIAN	10750	12300	13800	15350	16600	17800	19050	20250
	VERY LOW INCOME	17900	20500	23050	25600	27650	29700	31750	33800
	LOW-INCOME	28650	32750	36850	40950	44250	47500	50800	54050
Curry County, OR									
FY 2009 MFI: 44700	30% OF MEDIAN	10500	12000	13500	15000	16200	17400	18600	19800
	VERY LOW INCOME	17500	20000	22500	25000	27000	29000	31000	33000
	LOW-INCOME	28000	32000	36000	40000	43200	46400	49600	52800

New Mortgage Requirement

General Rule

Under §143(i), no part of the proceeds of the issue may be used to acquire or replace existing mortgages. In other words, qualified mortgage bonds may not be used for refinancing home loans.

This rule does not preclude refinancing construction loans or bridge loans or similar temporary initial financing.

Contract of Deed Exception

In the case of a borrower of bond proceeds who possesses, pursuant to a contract for deed, land upon which his principal residence is located, the "no refinancing" rule does not apply to such contract for deed if the borrower's family income is not more than 50 percent of the applicable median family income.

A "contract for deed" is a seller-financed contract to convey land where legal title does not pass until the purchase price is fully paid and the seller's remedy for nonpayment is forfeiture rather than foreclosure.

Exception for Qualified Rehabilitation Loans

Qualified rehabilitation loans are exempted from the new mortgage requirement, just as they are exempted from the three year requirement. This means that, in connection with a qualified rehabilitation, the mortgagor can refinance an existing mortgage as well as finance the rehabilitation costs, with proceeds of the bonds.

The term "qualified rehabilitation loan" means financing for a homeowner in connection with a qualified rehabilitation or the acquisition financing for a purchaser of a residence with respect to which there has been a qualified rehabilitation. The mortgagor must be the first resident of the home after completion of the qualified rehabilitation.

Qualified rehabilitations are limited in the amount of structural changes that may be made to the residence and the rehabilitation expenditures must constitute at lease 25 percent of the mortgagor's basis in the residence after the rehabilitation is completed. See §143(k)(5).

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New Mortgage Requirement, Continued

Assumptions

A purchaser may buy a residence from a mortgagor who utilized proceeds of qualified mortgage bonds by assuming the existing mortgage.

In this case, the principal residence and first time homebuyer requirements and the purchase price and income limitations must be met at the time of the assumption, using the limits that apply on the date of the assumption.

Refinancing Subprime Loans

Under the Housing and Economic Recovery Act of 2008, for bonds issued after July 30, 2008 and before January 1, 2011, the proceeds may be used to refinance "qualified subprime loans" during the first 12 months after the bonds are issued.

Qualified subprime loans are adjustable rate mortgage loans made after December 31, 2001 and before January 1, 2008 if the issuer determines that it would be reasonably likely to cause financial hardship to the borrower if the loan is not refinanced.

The first time homebuyer requirement does not apply.

Special Origination and Redemption Requirements

42 Month Limit on Origination of Mortgages

The lendable proceeds must be used for the mortgages within 42 months after the issue date.

Any amount not so used, other than a de minimis amount of less than $250,000, must be used to redeem bonds of the issue within this 42 month period. These redemptions are referred to as "non-origination calls."

Any de minimis amount not used for redemption can only be held for future redemptions. No financing of mortgages is permitted after the 42nd month.

10 Year Rule

Recycling of mortgage payments is permitted only within 10 years of the issue date.

Recycling occurs when the issuer uses principal payments it receives on the mortgages to make additional mortgage loans.

For this purpose, the issue date is the date of issuance of the bonds or, in the case of a refunding, the original bonds.

After the 10 year date, all receipts of principal on the mortgage loans must be used within six months to redeem bonds of the issue.

Again, there is a de minimis rule that accepts out amounts of less than $250,000 which may be held longer for future redemptions.

Arbitrage Restrictions

General Rule

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

Interest Rate on Mortgage

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

The comparison of effective rate of interest to bond yield is done by calculating the effective rate of interest on the aggregate pool of mortgage loans.

Effective Rate of Interest

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.

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. This increases the effective rate of interest.

Normal financing costs are not taken into account. "Normal" means not in excess of amounts charged in connection with loans that are not financed with qualified mortgage bonds.

Mortgage insurance premiums (including premiums for FHA, VA, Fannie Mae and Freddie Mac pool insurance) are not taken into account per Regulations §1.143(g)-1. This was a change from the rules under the earlier regulations.

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Arbitrage Restrictions, Continued

Prepayment Assumptions

In determining the effective rate of interest on the mortgages, it is assumed that the mortgages will experience prepayments of principal at a rate equal to 100 percent of the rate set forth in the most recent prepayment experience tables published by FHA.

(Section 143(g)(2)(B)(iv) and Regulations §6a.103A-2(i)(2)(iv)).

Yield on the Issue

The yield on the issue is determined on the basis of the issue price for the bonds and the expected maturity for the bonds, with redemptions of bonds assumed to be consistent with the mortgage prepayment assumption used in determining the effective rate of interest.

(Section 143(g)(2)(C) and Regulations §6a.103A-2(i)(2)(vi)).

The special redemption requirements discussed below will impact this calculation.

Mortgage Defaults and Mortgage Forgiveness

For mortgages that are not insured by FHA, VA, etc. or private mortgage insurance, recent default experience for mortgages within the area may be taken into account in determining the effective rate of interest on the mortgage pool. The issuer can exclude projected net losses (after foreclosure and collection of title and hazard insurance) on such uninsured mortgages from the assumed payments to be received on the mortgage pool.

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 remaining principal owed on all remaining mortgages when all related bonds are discharged.

Cancellation of indebtedness income may arise for the mortgagors whose principal was forgiven.

Note

In addition to the restrictions under §143(g), the issuer must meet the arbitrage and rebate requirements of §148 that apply to all bond issues qualifying for exemption under §103.

Recapture Tax

Imposition of Recapture Tax

Under §143(m), if a mortgagor who incurred a mortgage loan that was funded with proceeds of a qualified mortgage loan sells the residence within 9 years of the date of the loan of the proceeds to the mortgagor, the mortgagor may be liable for payment of a "recapture tax."

The amount of the recapture tax depends on:

- how long the mortgage was outstanding before the residence was sold
- the family income of the mortgagor at the time the residence is sold in relation to the amount of the income limitation in effect in the year of sale, **and**
- the amount of gain, if any, the mortgagor realizes from the sale, whether or not such gain is required to be recognized

Notice of Tax Required

The issuer of qualified mortgage bonds must give mortgagors notice of the "recapture tax" imposed pursuant to §143(m).

Failure to provide the notice will disqualify the bonds from eligibility as qualified mortgage bonds.

The notice must contain two components:

- At the time of settlement of the mortgage, the mortgagor must be informed of the potential that recapture tax will be imposed.
- Within 90 days after settlement, the issuer must inform the borrower of the "federally-subsidized amount" of indebtedness and the "adjusted qualifying income" for each category of family size for each year of the nine years following settlement.

The "federally-subsidized amount" is equal to 6.25% of the principal amount of the mortgage loan.

The "adjusted qualifying income" is the income limit in effect for each category of family size (*i.e.*, two or less and three or more) at the time the financing was provided, compounded by an additional 5 percent each year.

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Recapture Tax, Continued

Note Qualification of the bonds for tax exemption is only dependant upon the issuer providing the required notices. A homeowner's failure to pay the tax upon a disposition that triggers the tax otherwise will not affect the bond issue.

Qualified Veterans' Mortgage Bonds

General

Qualified veterans' mortgage bonds qualify for tax exemption. Under §143(b), to be a qualified veterans' mortgage bond:

- 95 percent or more of the net proceeds of the issue must be used to provide residences for qualified veterans,
- the residences must meet the "principal residence" requirement,
- the issue must meet the special arbitrage rules applicable to qualified mortgage bonds, and not meet the private business use and private security or payment tests under §141(b),
- the proceeds must not be used to refinance existing mortgages, **and**
- the special veterans' mortgage bond rules must be met

The first time homebuyer requirement, purchase price limits, income limits, targeted area requirement, special origination and redemption rules and recapture tax notification requirement do not apply.

Special veterans' mortgage bond rules

The bond issue must be secured by a general obligation of a State that issued qualified veterans' mortgage bonds before June 22, 1984.

Qualified veterans are veterans who served on active duty and applied for the financing within 25 years of the date the veteran left active service.

Note

The above rules effectively limit qualified veterans' mortgage bonds to bonds issued in Alaska, California, Oregon, Texas and Wisconsin.

Other Requirements

Other Private Activity Bond Rules

The following private activity bond rules are applicable to qualified mortgage bonds. The basic rules are not discussed in this lesson, as they are discussed in detail in various other lessons. This lesson does cover certain variances in application of these general rules to qualified mortgage bonds.

- 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 rules
  - No advance refundings
  - Information reporting to Service upon issuance
  - Required registration of bond ownership
- Section 55 alternative minimum tax

The following private activity bond rules under section 147 do not apply to qualified mortgage bonds:

- Substantial user requirement
- Limitation on average weighted maturity
- Limitation on land acquisition
- Prohibition on acquisition of used property

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Nuances for Qualified Mortgage Bonds

In determining qualification for the current refunding exception to the requirement for allocation of volume cap, issuers of qualified mortgage bonds usually opt to use the "32 year rule" under §146(h)(3).

In addition to using allocated volume cap to issue qualified mortgage bonds, a housing bond issuer may chose to issue mortgage credit certificates pursuant to §25. If an issuer issues mortgage credit certificates, it will forfeit volume cap for qualified mortgage bonds in that year in an amount equal to four times the amount of mortgage credit certificates issued.

Under the Housing and Economic Recovery Act of 2008, the amount of annual volume cap available to the states was increased by $11 billion for 2008, with such increased amount restricted to use for "qualified housing issues" issued before 2011. Qualified mortgage bonds are included in the definition of qualified housing issues if the proceeds are used for origination of mortgages (or non-origination calls) within 12 months of issuance rather than the 42 month period permitted under §143(a)(2)(D)(i).

Under §147(g)(2), for qualified mortgage bond issues with proceeds of $20 million or less, costs of issuance may be funded from proceeds in an amount up to 3.5 percent of the proceeds.

In addition to the filing 8038s, pursuant to Regulations §1.149(e)-1(b)(1)(iii), an issuer of qualified mortgage bonds must file with the Service annually the borrower information reports described in Regulations §1.103A-2(k)(2)(ii) and (k)(3) through (k)(6).

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Nuances for Qualified Mortgage Bonds (continued)

The federal guaranty provisions of §149(b) do not apply to qualified mortgage bonds unless they are structured to invest proceeds in federally insured deposits or accounts (the "FSLIC bonds" structure). Thus Federal Home Loan Bank letter of credit guarantees are permitted. See §149(b)(3)(C).

Under the Housing and Economic Recovery Act of 2008, qualified mortgage bonds and qualified veterans' mortgage bonds issued after July 30, 2008 are not an item of tax preference and are excluded from adjusted current earnings of corporations for purposes of the alternative minimum tax. This exclusion is permanent, unlike the AMT exclusion provisions applicable to private activity bonds found in the America Recovery and Reinvestment Act of 2009, which only apply to bonds issued in 2009 and 2010 and refundings of such bonds.

In response to natural disasters, special legislation has provided for relaxation of various targeting requirements for qualified mortgage bonds and qualified veteran's mortgage bonds. A recent example of such legislation is Section 404 of the Katrina Emergency Tax Relief Act of 2005.

Summary

Review of Lesson 8

Lesson 8 has discussed the requirements of qualified mortgage bonds.

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

- All of the proceeds of the bonds must be used to finance the owner-occupied residences described in §143.
- 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.
- At 95 percent of the net proceeds must be loaned to mortgagors that are "first-time homebuyers."
- Issuers must attempt to make loans in "targeted areas."
- 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.
- Bonds must be redeemed from unoriginated proceeds after 42 months, and bonds must be redeemed with mortgage payments received after the 10th year.

In addition to the restrictions in §148, §143(g) imposes additional arbitrage restrictions regarding the interest rate on the single-family loans. In addition to the rules set forth in §143, qualified mortgage bonds are also subject to most of the other rules governing private activity bonds, such as those found in §§146 through 150. There are nuances in the way these private activity bonds apply to qualified mortgage bonds.

Continued on next page

Summary of Lesson 8, Continued

Preview of Lesson 9

Lesson 9 continues the discussion of qualified private activity bonds by discussing student loan bonds. Student loan bonds have significant common features with mortgage revenue bonds, as both involve the financing of a portfolio of loans. But the tax rules are not the same.

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