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Mortgage Revenue Bonds: Analysis of Sections 3021 and 3022 of the Housing and Economic Recovery Act of 2008

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Summary

The number of homeowners facing the risk of foreclosure is rising and estimates suggest as many as 2.8 million borrowers may face the possible loss of their home over the next five years. Mortgage lending rules and credit are tightening as current and potential homeowners have fewer available financing choices.

The Housing and Economic Recovery Act of 2008, P.L. 110-289, changes the rules of the mortgage revenue bond (MRB) program to provide assistance to homeowners. Previous tax law allowed MRB proceeds to be used for mortgages to "first-time" home buyers. P.L. 110-289 allows proceeds to be used by current home owners to refinance certain loans, increases the amount of bond authority, and excludes interest earned on the bonds under the alternative minimum tax.

This report, which will be updated as warranted by legislative changes, provides an overview of the relevant aspects of the MRB program and discusses the recent changes.

Overview

Mortgage revenue bonds (MRBs) are one type of private activity bond issued by states and their political subdivisions, the interest on which is exempt from federal income taxes if the bonds qualify under rules stipulated in the tax code.[1] There are two types of

[1] For more information on tax-exempt bonds, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Steven Maguire, and CRS Report RL31457, *Private Activity Bonds: An Introduction*, by Steven Maguire.

MRBs: qualified mortgage bonds and qualified veterans' mortgage bonds. This report provides a general overview of qualified mortgage bonds.

Qualified mortgage bonds are sold as part of an issue, the proceeds of which must be used to finance owner-occupied residences.[2] In general, the residences must be single-family dwellings, located within the government-issuer's jurisdiction, that are reasonably expected to be the mortgager's principal residence within a reasonable time after the financing is provided.[3] The bonds may be used to finance two-, three-, and four-family residences if one unit is occupied by the owner and the residence was first occupied at least five years prior to the mortgage's execution.[4] Prior to P.L. 110-289, the financing was generally required to be for *new* mortgages and could be used to acquire or replace existing mortgages.[5] Additionally, proceeds must generally be used to finance residences within 42 months after the bonds' date of issuance, or be used to redeem bonds that are part of the issue.[6]

Bonds issued to finance "first-time" home buyers are subject to various other requirements. These include the "first-time" home-buyer requirement, under which at least 95% of the proceeds must be used to finance the residences of home buyers who have not owned a principal residence during the past three years.[7] Another requirement is that the home buyer's family income cannot exceed 115% of the applicable median family income.[8] This limitation is adjusted in certain cases (e.g., it is increased up to 140% if the residence is in an area with high housing costs). Another requirement under the MRB program is that the residence's purchase price generally cannot exceed 90% of the average purchase price of single- family residences sold in the area during the past year.[9]

Targeted Area Residences. Special rules apply to targeted area residences.[10] These are residences located in a census tract in which at least 70% of the families have incomes that are no more than 80% of the statewide median family income or in an area of chronic economic distress, as designated by the state with federal approval. Among other things, the "first-time" home buyer requirement does not apply; the purchase price limit is increased from 90% to 110%; and one-third of the financing may be provided without regard to the home buyers' income, with the rest provided to home buyers with family incomes that are no more than 140% (as opposed to 115%) of the applicable median family income.

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[2] IRC § 143.

[3] IRC § 143(c).

[4] IRC § 143(k)(7).

[5] IRC § 143(i)(1).

[6] IRC § 143(a)(2)(D).

[7] IRC § 143(d).

[8] IRC § 143(f).

[9] IRC § 143(e).

[10] IRC § 143(h) and (j).

Arbitrage. Mortgage revenue bonds are subject to the general arbitrage rules that restrict issuers from using tax-exempt bond proceeds to acquire higher yield investments.[11] Additionally, MRBs are subject to a special requirement that the effective rate of interest on the mortgage cannot exceed the bond yield by more than 1.125 percentage points.[12]

Recapture. A home buyer using the MRB program is receiving an indirect federal subsidy because his or her mortgage has a low interest rate due to it being financed by tax-exempt bonds. Thus, a home buyer who sells the residence may, if such sale was within nine years of the MRB financing, be required to pay back some of the benefits he or she received to the federal government.[13]

Program Administration

MRBs are administered through a mix of public and private partners. Bonds are typically issued by state housing finance agencies through financial intermediaries who sell the bonds to private investors. The bonds have lower interest rates than privately-issued bonds, but provide the benefit of being exempt from federal (and possibly state) income taxes.[14] State housing agencies do not directly lend the proceeds to home buyers; instead, the agencies provide funds to private lenders, and home buyers apply to the lenders for financing, just like a typical mortgage. The loan has below-market interest rates because it is financed through the issuance of tax-exempt bonds.

Volume Cap

The federal government restricts the amount of private activity bonds, of which qualified mortgage bonds are one type, that each state may issue during a year.[15] This limit is called the volume cap. Prior to P.L. 110-289, the 2008 limit for each state was originally set as the greater of $85 multiplied by the state's population or $262,095,000; these amounts are annually adjusted for inflation.[16] Some private activity bonds are not subject to the cap: qualified veterans' mortgage bonds, qualified 501(c)(3) bonds, and certain exempt facility bonds.[17]

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[11] IRC § 148.

[12] IRC § 143(g).

[13] IRC § 143(m).

[14] The interest on MRBs is included in income for purposes of calculating the alternative minimum tax (discussed below).

[15] IRC § 146. For more information, see CRS Report RL34159, *Private Activity Bonds: An Analysis of State Use*, by Steven Maguire.

[16] Rev. Proc. 2007-66; 2007-45 I.R.B. 970.

[17] IRC § 146(g).

Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) is intended to ensure that taxpayers cannot reduce their federal income taxes below a certain level by taking advantage of various tax preferences (e.g., credits, deductions, and exclusions).[18] Taxpayers subject to the AMT calculate their regular income tax liability and their AMT liability, and must pay whichever is higher. One step in calculating a taxpayer's AMT liability is adding back various tax preference items to his or her taxable income computed under the regular income tax. The interest on tax-exempt private activity bonds including, originally, mortgage revenue bonds is one such item that must be added back in.[19]

P.L. 110-289

The Housing and Economic Recovery Act of 2008, P.L. 110-289, made three changes to the MRB program. First, Section 3021 of the act allows the proceeds of a qualified mortgage issue to refinance mortgages on residences that were originally financed by qualified subprime loans. A qualified subprime loan is any adjustable rate single-family residential mortgage originated between December 31, 2001, and January 1, 2008, that the bond issuer determines would be reasonably likely to cause financial hardship to the borrower if not refinanced. The proceeds must be used for the refinancing within 12 months of the issuance (as opposed to 42 months), the "first-time" home buyer requirement does not apply, and the purchase price requirement is applied using the residence's market value at the time of refinancing. The refinancing provision only applies to bonds issued before January 1, 2011.

Section 3021 also increases the volume cap for 2008. The extra amount can only be used to issue exempt bonds used to provide qualified residential rental projects[20] or qualified mortgage bonds. Each state's ceiling is increased by $11 billion multiplied by the percentage its population bore to the entire U.S. population. States are able to carry forward unused allocations, but the amounts can not be used to issue bonds after 2010.

The third change relates to the alternative minimum tax (AMT). As explained above, under the original law, taxpayers were typically required to include the interest earned on MRBs when computing their AMT liability. Section 3022 of P.L. 110-289 permanently excludes such interest for qualified mortgage bonds and qualified veterans' mortgage bonds issued after the provision's enactment.

Analysis

The recent changes expand the purposes for which mortgage revenue bond proceeds can be used, increase the bond allocation authority of issuers, and allow the income

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[18] For more information on the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

[19] IRC § 57(a)(5).

[20] Exempt facility bonds, which are another type of tax-exempt private activity bond, may be issued to finance qualified residential rental projects. Among other requirements, at least some of the rental units must be occupied by low-income renters. IRC § 142(d).

earned on the bonds to be excluded against the alternative minimum tax (AMT). The proposed changes are estimated to cost less than $36 million for FY2008 and $1.87 million through FY2013.[21]

Expansion of Program. As mentioned previously, prior law allowed MRB proceeds to be used for "first-time" home buyers, subject to certain eligibility and for financing multi-family housing development. The new law allows existing homeowners to participate in the program to refinance subprime loans, adding to the types of eligible program participants. This change expands the program.

The program expansion may allow some homeowners to avoid foreclosure. As a financing tool, the lower rates offered by the MRB program, relative to banks and other mortgage lenders, could provide assistance to troubled homeowners who cannot afford market-rate loans. Borrowers with poor credit or who owe more than their house is worth may not be helped by the MRB program because the criteria for program lending are as rigorous as those used by traditional lenders. In fact, a few states (Colorado, Ohio, and Maryland for example) started loan programs for refinancing with taxable bonds and found few qualified borrowers.[22] Some policy makers have argued that the lending criteria of the MRB program should be relaxed to allow more borrowers to receive assistance. Opponents of that policy proposal could assert that the credit rating of the bond issuer must be preserved; if higher-risk loans are made, the credit rating of bonds may fall and the proceeds from the bond issuance for mortgages would decline. If the credit rating falls, then it becomes more costly for the issuer to sell debt. The higher cost of debt could make the MRB financing option less attractive to issuers.

Increase in Bond Allocation Authority. The increased bond allocation authority will allow states to authorize more tax-exempt debt for mortgages. The lower cost of funds for lenders and home buyers may be beneficial as problems with mortgage-backed securities and foreclosures are limiting the amount of capital available from traditional mortgage lenders.

To the extent that the lower interest rates of the MRB program lower the cost of housing, then demand for homes may rise. The increased demand for homes would come at a time when policymakers are most concerned about housing-market slowdowns due to an excess supply of homes on the market.

The increase in allocation authority may help to minimize competition for bond proceeds. As MRB program eligibility is expanded, the demand for the program increases, creating more competition among bond-financed projects.[23] Increasing bond allocation while expanding the program could potentially minimize any unintended

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[21] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of Tax Provisions Contained in H.R. 3221 "The Housing and Economic Recovery Act of 2008,"* JCX-64-08 (Washington: GPO, 2008), p. 2.

[22] Peter Schroeder, "Subprime Assistance; HFAs Look for Private Activity Cap Increase," *The Bond Buyer*, vol. 363, January 3, 2008, p.1.

[23] As noted earlier in this report, MRBs are part of the larger pool of private activity bonds. Private activity bonds are allocated to states, and states choose how to allocate the bonds among projects for owner-occupied housing, rental housing, economic development, or other programs.

consequences caused by competition for bond proceeds. Additionally, unused bond authority can be carried forward temporarily, allowing agencies to manage housing finance as needed over time. The increase in allocation authority will create more bond issues and more interest earnings on the bonds, which will, for the most part, go untaxed.

The federal cost of the current MRB program, which is estimated at $1.4 billion in FY2008, has been justified as necessary to encourage first-time home ownership for disadvantaged borrowers.[24] Given the expense of existing housing tax provisions, it could be argued that owner-occupied housing is heavily subsidized. For FY2008 the federal revenue loss associated with housing tax preferences includes $85.2 billion for the deduction for mortgage interest; $30.1 billion for the exclusion of capital gains on the sales of homes; and $14.2 billion for the deduction of state and local real-estate taxes.[25]

Economic theory suggests that the use of tax preferences to change the borrowing and consumption choices of individuals generates inefficiencies. These inefficiencies are accepted as necessary, as noted above, to advance the social goal of increasing home ownership among selected individuals. Expanding the MRB program will increase the revenue loss and increase these economic inefficiencies. Again, it could be argued that the perceived social and economic benefits from expanding MRBs justify the federal revenue loss.

Allowance of MRB Income Exclusion Against Alternative Minimum Tax. The change to allow the interest earned on MRB bonds to be excluded from income when calculating the alternative minimum tax (AMT) could increase demand by investors for MRBs. Increased demand could be expected because the income exclusion against the AMT could make the bonds more attractive investment vehicles for investors. If this is the case, the policy change will increase the revenue loss associated with the program, as taxpayers who formerly would have had to claim interest earnings on the bonds as income no longer have to do so.

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[24] U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007 to 2011*, JCS-3-07 (Washington: GPO, 2007), p. 27.

[25] Ibid.