



Program Bulletin

May 3, 2002

Program Bulletin #2002-18

**To: CHFA Approved Lenders
Cities, Counties, Housing Authorities, Nonprofit Entities and
Redevelopment Agencies**

SUBORDINATE FINANCING AND RESALE CONTROLS & AFFORDABLE HOUSING PARTNERSHIP PROGRAM

This program bulletin supercedes Bulletin #97-09, dated March 19, 1997 and Bulletin #97-18, dated August 5, 1997 and combines both subjects into one bulletin. The purpose of combining both subjects is to help define the partnership between California Housing Finance Agency (CHFA) and localities (*defined as cities, counties, housing authorities, nonprofit entities and redevelopment agencies*) and outline the process localities/lenders will use to get programs approved.

CHFA's Bond Counsel must pre-approve all subordinate loans and/or resale controls that are used in conjunction with a CHFA first mortgage. This combination of a CHFA first mortgage and a locality subordinate loan or grant is what CHFA calls the Affordable Housing Partnership Program (AHPP). Additionally, low-income first-time homebuyers will receive a preferential interest rate first mortgage when using AHPP. These rates are generally 25 basis points (0.25%) below the standard low income interest rates for both High Cost and Statewide Areas.

CHFA's Bond Counsel has established a guide for acceptable subordinate loans and resale controls. This guide is attached. The policies described within this bulletin and attachments apply to all locality subordinate loans and/or resale controls. Subordinate loans or resale controls from private sources will not be accepted.

Borrowers must receive direct financial assistance, e.g., downpayment assistance, closing cost assistance, or deferred-payment subordinate loans, from the locality. Land write-downs, density bonuses, fee waivers, fee deferrals, and other indirect assistance from a locality or developer will not qualify for purposes

of obtaining the AHPP interest rate. However, CHFA will accept loan reservations with indirect forms of assistance at CHFA's standard interest rate so long as these programs have been approved by CHFA's Bond Counsel.

Localities or lenders working on behalf of a locality wishing to have their programs reviewed by CHFA Bond Counsel must submit to CHFA Special Programs Unit copies of all Notes, Deeds of Trust, Loan Agreements, Resale Control Agreements and/or any other documents the borrowers will be required to sign at the close of escrow. This includes grants and no interest (forgivable) loans. CHFA will forward the documentation to CHFA's Bond Counsel for a compliance review. Allow 4-6 weeks review time by CHFA's Bond Counsel. CHFA will notify the locality/lender of approval or denial of the subordinate loan and/or resale controls.

All localities are required to execute a CHFA Subordinate Financing and Resale Control Agreement (11-30-01), copy attached, when their program is approved by Bond Counsel. To help speed up the review time and execution of this form, localities may complete and sign the form in advance of approval and submit it to CHFA's Special Programs Unit with the documents to be reviewed by Bond Counsel. If the program is approved, CHFA will countersign the form and a signed copy will be returned to the locality/lender. CHFA will only execute the signed original form. Pre-signing the form does not obligate the locality in anyway if a program is not approved. Any changes to previously approved documents must be resubmitted for approval by Bond Counsel.

Program highlights are:

- ❖ All areas in California are eligible for AHPP.
- ❖ Borrowers must be low-income (as defined by CHFA) to receive the AHPP interest rate on the CHFA first mortgage. Moderate-income borrowers may utilize the approved subordinate program, but will not receive the preferential AHPP interest rate.
- ❖ Eligibility requirements for the borrower and property can be provided by a CHFA-approved lender. Localities are reminded that borrowers in this program must be first-time homebuyers, unless the property is located in a federally-designated Targeted Area. CHFA-approved lenders can provide the Targeted Areas in your jurisdiction. CHFA can also provide a list of the federally-designated Targeted Areas Census Tract Numbers.
- ❖ Prior to making a loan reservation which involves a subordinate loan, Lenders are required to check the Affordable Housing Partnership Programs' Approved Subordinate Localities and Programs list that is updated monthly and is available on CHFA's webpage at:

<http://www.chfa.ca.gov/homeownership/downpayment/ahpp-approved.pdf>

- ❖ All subordinate financing and resale controls are also subject to the approval of the applicable mortgage insurer.

Please note: *Lenders should not make loan reservations or submit conditional approval packages to CHFA until the associated subordinate loan and/or resale control documentation has been approved.* If there are questions as to whether a particular locality subordinate loan and/or resale control has been approved, you may either mail or fax a copy of the documentation to CHFA Special Programs Unit. The mailing address and fax number are listed at the end of this bulletin. CHFA staff will verify the status of the documentation and notify the lender.

*Lenders are required to include copies of all subordinate loan and/or resale control documents (whatever is applicable) in **each** loan file submitted to CHFA for conditional approval.* CHFA underwriting staff will review the documentation to ensure it has been previously approved. If the documentation is not included in the file, CHFA will suspend the loan, pending submittal of the documentation. If the documentation is not supplied within a reasonable period of time, CHFA will reject the loan (which will also cancel the reservation).

Questions regarding this bulletin should be directed to CHFA, Homeownership Programs at 1121 L Street, 7th Floor, Sacramento, CA 95814; by phone (916) 324-8088; by fax (916) 324-6589; by e-mail at homeownership@chfa.ca.gov or visit CHFA's website at: www.chfa.ca.gov

Attachments



Lenders are encouraged to use CHFA's FHA Energy Efficient Mortgage Program (EEM) to minimize energy usage and costs. Additional information regarding EEMs is available on CHFA's web page.

MEMORANDUM

TO: California Housing Finance Agency
Single Family Programs Division

FROM: Orrick, Herrington & Sutcliffe

SUBJECT: SUBORDINATE FINANCING AND RESALE CONTROLS

DATE: May 6, 1994 Revision (original date was March 11, 1992)

BACKGROUND

This memorandum summarizes the advice we have given the Agency as of May 6, 1994 concerning the use of tax-exempt bond proceeds to purchase mortgages on single family homes that are the subject of local or State subordinate financing or resale control programs. One of the requirements for interest on such bonds to be tax-exempt is that except as provided in Section 143 (k)(10) of the Internal Revenue Code with respect to certain "high housing cost areas", all of the homes financed by the bonds must be owner-occupied under federal tax ownership principles. Some programs designed to preserve the affordability of units for purchase and repurchase by lower income households take away from such households most of the benefit of appreciation in the value of their homes. Under these circumstances, it is often difficult to conclude that for federal tax purposes such a household owns the unit in which they are living. As a result, many housing affordability programs, though highly laudable from a public policy perspective, may not be financeable with tax-exempt bonds.

It is a well-established principle of federal tax law that ownership for federal tax purposes is determined by looking at the economic substance of the transaction, and not at the state law characterization (i.e., not by simply determining who has title to the property). One of the primary attributes of ownership under the federal tax rules is the right to benefit from appreciation in the value of the property. Where that right is shared by the title owner with another party, the Internal Revenue Service has only grudgingly (and in relatively few instances) concluded that the title owner is the owner for federal tax purposes. For example, Revenue Ruling 83-51 concludes that under very restricted circumstances, a shared-appreciation mortgage loan used to finance the purchase of a personal residence results in a debtor-creditor relationship (rather than a joint venture or other joint ownership arrangement). Since the publication of that ruling, the Internal Revenue Service has announced that the shared-appreciation area is one in which they will not issue rulings or determination letters. See, e.g. Revenue Procedures 88-3.

Similarly, the IRS has held that the holder of an option to buy property may be treated as the owner of the property for federal tax purposes unless the option price reasonably approximates the anticipated fair market value on the option date. Revenue Ruling 55-540, 1955-2c.b.39. See also Frank Lyon Co. v. United States, 435 U.S. 561-79=1 U.S.T.C. paragraph 9370 at 83,882, n.14; and Rev. Proc. 75.21, 1975-1 C.B. 715. Some affordability programs give an option to the local government to purchase the home and limit the resale price to increases proportional to increases in median income. Historically, rates of appreciation of real property have exceeded rates of increase in median income. As a result, it is likely that (and it is the purpose of such programs to preserve affordability if) the value of a residence will substantially exceed the price at which the occupant is permitted to sell under the resale price restriction. Under these circumstances, a material question is created as to whether the local government (or a joint venture between the occupant and the local government) has an ownership interest in the property that would render it ineligible for financing with qualified mortgage bonds.

High housing cost area exception. For residences being financed by "new money" bonds issued after August, 1993, Section 143 of the Internal Revenue Code was amended to permit the interest of a governmental unit in a residence by reason of certain "qualified programs" not to be

taken into account under Section 143, i.e. to permit certain resale price control and subsidy lien programs to be ignored when determining, among other things, whether a residence was owner-occupied, but only if the residence is in a high housing cost area. A “qualified program” is a governmental program which (a) provides subordinate mortgage loans (not financed with tax-exempt bonds) or grants, and (b) either

(i) restricts for at least nine (9) years the sale of the residence to a purchaser that qualifies under Section 143 (“first time homebuyers” meeting the income limits) and to a price determined by an index that reflects less than the full amount of any appreciation in the residence’s value, or

(ii) provides for deferred or reduced interest payments on the subordinate mortgage loan and grants the governmental unit a share in the appreciation of the residence not greater than the share of the purchase price financed by the subordinate mortgage loan.

Please note that “high housing cost area” is defined in specific terms concerning the relationship between the average area purchase prices for new and existing residences and area median income, and that the areas that qualify may change from time to time as average area purchase prices and area median incomes change.

PERMITTED TYPES OF PROGRAMS

As a result, we can now approve “qualified programs” in “high housing cost areas”, as well as the following types of transactions in which the affordability restriction is accomplished through a relationship that has a characterization under federal tax law that is consistent with ownership by the occupant.

1. Debtor-Creditor Relationship. In these programs, the value of the local government’s subsidy is characterized as a loan which bears deferred, compounded interest at quasi-market rates. In other words, at the time of initial sale to a low or moderate income person, the excess of the fair market value of the residence over the subsidized price at which the residence is being sold is documented as a second mortgage loan which bears interest at a rate greater than equity line of credit rates and less than credit card rates, depending on the commercial risk associated with repayment of the loan. Interest is deferred and compounded, and both principal and interest on the loan are payable only upon sale or transfer of the residence (or earlier if the program requires). Sometimes the percentage interest rate is accompanied by contingent, deferred interest in the form of a share of the appreciation in value of the residence. We have concluded that such shared appreciation mortgages must meet the standard of Revenue Ruling 83-51 which limits the appreciation share to one-half of the percentage of the value of the residence financed by the shared-appreciation loan. That is, if the loan represents 20% of the initial value of the residence, a maximum of 10% of the appreciation may be treated as contingent, deferred interest. These programs often also waive any accumulated interest that would, if paid, result in the owner losing his or her downpayment, not being able to pay any recapture liability under § 143 (m) of the Internal Revenue Code or not receiving any appreciation.

2. Zoning Regulation. Where units are subjected to resale price restrictions under the terms of a zoning ordinance that is applicable to all residential development, under federal tax principles those restrictions determine the nature of the property that is owned, and not who owns it. As a result, we have approved broadly applicable inclusionary zoning ordinances. (Unfortunately, where resale restrictions are applicable because of a cash or other subsidy by the local government and not from a generally applicable zoning ordinance, the very same restrictions cannot be permitted.)

3. Short-Term Arrangements. Finally, where the restriction period is only a fraction of the economic life of the residence and the occupant can, in effect, earn the right to sell the residence at fair market value by living in the residence for a period of time, federal tax principles would treat the occupant as the owner. For example, we have approved resale price controls that terminate after ten years.

4. Other Possible Programs. We recognize that these distinctions may not make much sense from a housing policy (as opposed to a tax policy) perspective. We will continue to try to be creative in analyzing subordinate financing and resale price control programs for approval.



**CALIFORNIA HOUSING FINANCE AGENCY
SUBORDINATE LENDER/CHFA
SUBORDINATE FINANCING AND RESALE CONTROL AGREEMENT**

This Subordinate Lender/CHFA Subordinate Financing and Resale Control Agreement (the "Agreement") is made and entered into on _____, by and between the California Housing Finance Agency (the "CHFA") a public instrumentality and a political subdivision of the State of California, and _____ (the "Subordinate Lender").

RECITALS

A. CHFA intends to make a commitment to provide below-market rate mortgage financing (the "CHFA Loan(s)") to facilitate the acquisition by low- and moderate-income borrowers (the "Borrower(s)") of single family homes located in _____, _____ County, California and more particularly described as follows (the "Home(s)"): _____

B. Subordinate Lender intends to provide additional financial assistance for such acquisition and/or to impose restrictions on the transfer of the Homes as provided in those certain documents attached hereto and incorporated herein by this reference (collectively the "Subordinate Lender Documents").

C. In order to ensure that the Subordinate Lender Documents (1) are consistent with certain federal tax law requirements relating to CHFA's tax exempt bond financed loans, and (2) are subordinate to the CHFA Loan(s), the parties hereto have entered into this Agreement.

NOW, THEREFORE, the parties hereto agree as follows:

1. *Subordinate Lender Documents.* The Subordinate Lender represents and warrants that all of the financing documents and transfer restrictions which will be imposed on the Borrowers or the Homes by Subordinate Lender or otherwise in connection with the provision of its financial assistance or imposition of its transfer restrictions are included in the documents described herein as the "Subordinate Lender Documents".

2. *Representations to Bond Counsel.* The Subordinate Lender represents and warrants that any factual representations made to CHFA's bond counsel in connection with the Subordinate Lender Documents are and will be accurate and complete to the best of its knowledge.

3. *Amendment.* The Subordinate Lender Documents shall not be revised or amended without the prior written consent of CHFA.

4. *Subordination.* The Subordinate Lender Documents shall be subordinate to the CHFA Loan(s) and foreclosure of any CHFA deed of trust shall extinguish the Subordinate Lender Documents as encumbrances on the Home being foreclosed. The Subordinate Lender shall take all actions and execute all documents as necessary to cause such subordination and enable CHFA to obtain title insurance which insures the CHFA Loans(s) as superior to the Subordinate Lender Documents.

5. *Attorney Fees, Remedies.* In any proceeding to enforce this Agreement, the prevailing party shall be entitled to receive from the other party reasonable attorneys fees and costs. In the event of the inaccuracy or breach of any of the representations, warranties or agreements of Subordinate Lender contained herein CHFA may pursue any remedies available at law or in equity to redress any damage resulting to CHFA.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date set forth above.

CALIFORNIA HOUSING FINANCE AGENCY

SUBORDINATE LENDER

By: _____

By: _____

Name: _____

Name: _____

Title: _____

Title: _____