

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR PART 203

[Docket No. FR-5087-P-01]

RIN 2502-AI52

Standards for Mortgagor's Investment in Mortgaged Property

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Proposed rule.

SUMMARY: Through this proposed rule, HUD submits, for public comment, specific standards governing a mortgagor's investment in property for which the mortgage is insured by the Federal Housing Administration (FHA). Specifically, this proposed rule would codify HUD's longstanding practice, authorized by statute, of allowing a mortgagor's investment to be derived from gifts by family members and certain organizations.

The standards would address a situation in which the mortgagor's investment is derived from a gift, loan, or other payment that is provided by any donor, including an individual or an organization, and would also specify prohibited sources for a mortgagor's investment. The proposed rule would establish that a prohibited source of downpayment assistance is a payment that consists, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale: (1) The seller, or any other person or entity that financially benefits from the transaction; or (2) any third party or entity that is reimbursed directly or indirectly by any of the parties listed in clause (1).

DATES: *Comments Due Date:* July 10, 2007.

ADDRESSES: Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 10276, Washington, DC 20410-0500. Communications should refer to the above docket number and title.

Comment by Mail. Please note that due to security measures at all federal agencies, submission of comments by mail often results in delayed delivery.

Electronic Submission of Comments. HUD now accepts comments electronically. Interested persons may now submit comments electronically through the Federal eRulemaking Portal at www.regulations.gov. HUD strongly encourages commenters to submit

comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available for public viewing. Commenters should follow the instructions provided at www.regulations.gov to submit comments electronically.

No Facsimile Comments. Facsimile (Fax) comments are not acceptable. In all cases, communications must refer to the docket number and title.

Public Inspection of Public Comments. All comments and communications submitted will be available, without revision, for inspection and downloading at www.regulations.gov. Comments are also available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the Office of Regulations. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the comments by calling the Regulations Division at (202) 708-3055 (this is not a toll-free number).

FOR FURTHER INFORMATION CONTACT:

James Beavers, Acting Director, Office of Single Family Program Development, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410; telephone (202) 708-2121 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at (800) 877-8339.

SUPPLEMENTARY INFORMATION:

Background

In order for a mortgage to be eligible for insurance by the Federal Housing Administration (FHA), section 203(b)(9) of the National Housing Act (12 U.S.C. 1709(b)(9)) requires the mortgagor (with narrow exceptions) to pay on account of the property at least 3 percent of the cost of acquisition. The statute and the implementing regulation at 24 CFR 203.19 are silent about permissible or impermissible sources of the mortgagor's investment, except that some loans are permitted sources under the statute. For example, section 203(b)(9) of the National Housing Act permits family members to provide loans to other family members, and permits the mortgagor's downpayment to be paid by a corporation or person other than the mortgagor in certain circumstances, such as when the mortgagor is 60 years of age or older, or when the mortgage covers a housing unit in a homeownership program

under the Homeownership and Opportunity through HOPE Act (Title IV of Pub. L. 101-625, 104 Stat. 4148, approved November 28, 1990).

In a 1999 proposed rule, HUD addressed the subject of prohibited sources of downpayment assistance. At that time, downpayment assistance from seller-funded or reimbursed charitable organizations was a matter of concern to HUD. (See HUD's proposed rule published on September 14, 1999, 64 FR 49956.) In 2001, HUD withdrew the 1999 proposed rule. (See January 12, 2001, notice of withdrawal of proposed rule at 66 FR 2851.) The matter, however, remains of concern to HUD. Gifts for homeowners' downpayments from charitable organizations have continued to raise concerns in those cases in which the seller, or any party that financially benefits from the transaction, contributes funds to the mortgagor's downpayment. A party that might benefit from the transaction may be a family member of the seller, a real estate agent, or a broker.

Although FHA has attempted to preclude downpayment funding derived from contributions of the seller of the property, some charitable organizations have been able to circumvent these restrictions in various ways, including the establishment of a fund that provides the so-called "gift" to the homebuyer. The situations that cause FHA concern are primarily those in which the fund is replenished after loan closing by the seller who provides a "charitable donation" and, in some cases, pays a "service fee" to the organization from the proceeds of the sale of the house and does so only if the homebuyer is using the charitable organization's downpayment assistance program. In these cases, there is a clear *quid pro quo* between the homebuyer's purchase of the property and the seller's "contribution" or payment to the charitable organization. This is also true if the contribution to the charitable organization comes from an entity other than the seller that has an expectation of being reimbursed by the seller. Often, these contributions function as an inducement to purchase the home.

FHA's primary concern with these transactions is that the sales price is often increased to ensure that the seller's net proceeds are not diminished, and such increase in sales price is often to the detriment of the borrower and FHA. A Government Accountability Office (GAO) report released in 2005 entitled "Mortgage Financing Actions Need to Help FHA Manage Risks from New Loan Products" (GAO Mortgage Financing Report) stated that Fannie Mae and Freddie Mac do not allow

seller-related contributions to the downpayment, and that seller-related contributions could contribute to an overvaluation of the price of the property (GAO Mortgage Financing Report at page 16).

In May 2006, the Internal Revenue Service (IRS) addressed these same concerns by issuing Revenue Ruling 2006-27, which provides guidelines on organizations that may provide downpayment assistance to homebuyers and qualify as tax-exempt charitable or educational organizations under Internal Revenue Code (IRC) section 501(c)(3), and those that do not qualify for this tax-exempt status. The IRS, in its press announcement of the ruling, stated that funneling downpayment assistance from sellers to buyers through "self-serving, circular-financing arrangements" is inconsistent with operation as a section 501(c)(3) charitable organization. The IRS stated that, in a typical scheme, there is a direct correlation between the amount of the downpayment assistance provided to the buyer and the payment received from the seller, the seller pays the organization only if the sale closes, and the organization usually charges an additional fee for its services. The IRS noted that so-called charities that manipulate the system do more than mislead honest homebuyers; these organizations ultimately cause an increase in the cost of the home and damage the image of honest, legitimate charities. (See IRS News Release of May 4, 2006, at <http://www.irs.gov/newsroom/article/0,id=156675,00.html>.)

As the IRS also noted in its press release, inflated sales prices are often found on properties purchased with downpayment assistance from seller-funded nonprofit programs. Unlike true gifts that reduce the amount of the purchase price financed by the homeowner, such seller contributions increase the sales price of the home and result in higher mortgage payments. As noted by the revenue ruling, inflated sales prices result in inflated mortgage amounts, which increase the severity of individual claims on the FHA Insurance Fund and FHA losses on claims paid on such mortgages. Given that seller-funded gift programs thrive in stagnant or depreciating housing markets, the risk to FHA increases if FHA cannot recover the full amount owed when FHA acquires and resells a home that had been purchased by a participating borrower who had defaulted on the FHA-insured loan.

This Proposed Rule

This proposed rule would codify standards regarding the use of gifts as a

source of the mortgagor's investment in the mortgaged property, and would also specify prohibited sources for a mortgagor's investment. Permissible sources of gifts as a source of the mortgagor's investment include a family member, a governmental or public agency, the borrower's employer or labor union, and a charitable organization that qualifies as a tax-exempt charitable or educational organization under section 501(c)(3) of the IRC of 1986. The proposed rule would establish that a prohibited source of downpayment assistance is a payment that consists, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale: (1) The seller, or any other person or entity that financially benefits from the transaction; or (2) any third party or entity (referred to as a "donor") that is reimbursed directly or indirectly by any of the parties listed in clause (1). The use of the term "indirectly" in this proposed rule precludes the seller from providing the donor with funds through an individual or organization other than the seller, such as a family member of the seller. The use of the term "financially benefits" in this proposed rule is intended to capture, for example, real estate agents or real estate brokers who would benefit from the sale of the home to the mortgagor. The concern is that the problems with seller-funded contributions, as described earlier in this preamble, exist regardless of the route by which the funds are provided to the mortgagor.

A prohibited source of downpayment assistance, as defined in this rule, would apply to sales of existing homes by private sellers as well as sales by builders, developers, and others involved in new construction, or any party that financially benefits from the transaction. HUD would not allow any form of downpayment assistance, in any of its programs, if the downpayment assistance is derived, in whole or in part, directly or indirectly, from prohibited funds as described in this rule.

While the proposed rule is intended to prevent sellers from funding downpayments in their own home sales transactions, the proposed rule is not intended to preclude sellers from contributing to charitable organizations, which are often sources of donor downpayment assistance, that provide downpayment assistance that is unrelated in any manner to any properties sold by the seller. In addition, the rule is not intended to preclude reasonable assistance with closing costs not related to the

minimum investment, which may be permitted under local practice. Nothing in this rule proposes to change HUD's policy of allowing builders and other sellers to offer cash incentives to homebuyers, provided that any cash or cash equivalent given to a homebuyer before, at, or after closing results in a proportionate reduction to the mortgage; an amount which the homebuyer then would have to provide as additional funds at closing. The primary focus of this rule is to establish appropriate standards for downpayment assistance to a homebuyer that is categorized as a gift.

HUD currently requires that the gift to the borrower that is to serve as an investment in the property to be purchased must be documented in writing. The lender must document the gift funds through a letter signed by the donor and the borrower specifying, among other things, information about the donor, that no repayment by the borrower is required, and describing the relationship between the donor and the borrower. This proposed rule does not propose to change these current practices. Therefore, given the continued concerns about gifts based on seller-funded contributions, this rule proposes the following regulatory changes to 24 CFR 203.19.

HUD's current regulation of the mortgagor's minimum payment requirement is found at 24 CFR 203.19. As proposed to be revised by this rule, § 203.19 would have the following organization:

Paragraph (a) would require a mortgagor to have the funds needed to complete the transaction (payment of purchase price and settlement costs) in addition to the funds provided by the insured mortgage. This basic policy was previously stated only in a handbook rather than a regulation, but it is a basic requirement of mortgage lending and does not represent a new substantive policy.

Paragraph (b) would correspond with the first part of section 203(b)(9) of the National Housing Act by stating the basic rule for a 3 percent mortgagor cash investment. The statute and the current regulation give HUD the discretion to require more than 3 percent, but it is no longer necessary to reserve this discretion in regulations. In practice, HUD has not required more than 3 percent, except as needed to satisfy the basic requirement for cash sufficient to close the transaction (as stated in proposed new paragraph (a)). Both the statute and the current regulation exempt the following from the 3 percent requirement: (1) Veterans who can qualify under section 203(b)(2) of the

National Housing Act and (2) disaster victims who can qualify for 100 percent mortgage financing under section 203(h) of the National Housing Act. However, HUD's current regulation in § 203.19(a)(2) imposes a \$200 minimum cash investment requirement for those mortgagors. That \$200 requirement is no longer meaningful in relation to vast increases in home values and mortgage amounts since the \$200 requirement was adopted, and HUD proposes to delete it from the regulations in the interest of simplifying mortgage processing.

Paragraph (c) of the proposed rule would establish prohibited sources of downpayment assistance, as discussed in this preamble. HUD, however, has recognized local market practices in which sellers customarily agree to pay some of the buyer's closing costs. Beginning in the mid-1980's, HUD's administrative policies reflected in mortgagee letters and handbooks have permitted some seller contributions, consistent with local market practices that would be reflected in local appraisal practices, but never more than 6 percent of the purchase price. Proposed paragraph (c) will not prohibit reasonable seller contributions to closing costs.

Paragraph (d) would state the general policy that funds from loans or gifts may not be used for any part of the mortgagor's minimum investment, unless otherwise permitted by the rule.

Paragraph (e), like current § 203.19(b), would identify certain loan sources authorized by statute. The paragraph would clearly state HUD's historical understanding of the congressional intent behind section 203(b)(9) of the National Housing Act, which is that loans are a forbidden source of the 3 percent minimum investment unless a statute provides otherwise.

Paragraph (e) would also include certain statutory authorizations on which HUD relies, but which are currently not stated or referenced in regulations (family loans and government loan programs). Although paragraph (e) would restrict only the use of loans for the 3 percent minimum cash investment and would not apply to the rest of the required investment, it is important to note that 24 CFR 203.32 contains restrictions on secondary financing that is unsecured or secured by the home. Paragraph (e) would not supersede § 203.32.

Finally, paragraph (f) would list the limited permissible sources of gifts.

Findings and Certifications

Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed this rule under Executive Order 12866, *Regulatory Planning and Review*. OMB determined that this rule is a "significant regulatory action," as defined in section 3(f) of the Order (although not an economically significant regulatory action under the Order). The docket file is available for public inspection in the Regulations Division, Office of General Counsel, Room 10276, 451 Seventh Street, SW., Washington, DC 20410-0500. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the docket file by calling the Regulations Division at (202) 708-3055 (this is not a toll-free number).

Environmental Review

A Finding of No Significant Impact is not required for this proposed rule. Under 24 CFR 50.19(b)(6), this proposed rule is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4332 *et seq.*).

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. 601 *et seq.*) generally requires an agency to conduct a regulatory flexibility analysis of any rule subject to notice and comment rulemaking requirements, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities.

The purpose of this rule, as noted in the preamble, is to establish standards regarding the use of gifts by borrowers with an FHA-insured mortgage—primarily standards that would address gifts by charitable organizations—as a source of an FHA mortgagor's investment in the mortgaged property. To date, HUD's practice has been to limit permissible sources of gifts to family members, governmental agencies, employer of the mortgagor, labor union of the mortgagor, or charitable organizations. HUD is not narrowing the sources of gifts through this rulemaking but rather striving to ensure that gifts are gifts and that especially in the situation of gifts from charitable organizations, the gift is not a *quid pro quo* between the homebuyer's purchase of the property and the seller's "contribution" or payment to the charitable organization.

The prohibited sources of downpayment assistance, as structured in this proposed rule, are narrow and should not encompass a substantial

number of small entities that are engaged in downpayment assistance to homebuyers, which, to date, have primarily been charitable organizations with tax-exempt status.

As noted earlier in this preamble, the IRS, in Revenue Ruling 2006-27, has ruled that an organization that relies "on sellers and other real-estate related businesses that stand to benefit from the transaction" to finance downpayment assistance provided as part of the same transaction does not qualify as charitable organizations described in section 501(c)(3) of the IRC. Organizations that meet the criteria of section 501(c)(3) qualify for exemption from federal income taxation pursuant to IRC section 501(a). HUD's proposed rulemaking will not have any significant economic impact on small entities that qualify as charitable organizations described in section 501(c)(3) of the IRC and are exempt from tax under section 501(a) of the IRC because existing law prevents those organizations from providing seller-financed downpayment assistance while maintaining their tax-exempt status.

The IRS ruling also describes two organizations that provide downpayment assistance and qualify as charitable organizations described in section 501(c)(3) of the IRC and are exempt from tax under section 501(a) of the IRC. These organizations do not accept contributions from sellers that are contingent upon the sale of the seller's property. They follow additional policies and procedures that ensure that any benefit to sellers or other parties with an interest in selling homes is incidental to any transaction in which the charitable organization provides downpayment assistance. The organizations will accept contributions from property sellers, but only if the contributions are not contingent on the sale of the seller's property or a *quid pro quo* for the sale of the property. HUD's proposed rule permits downpayment assistance to be provided by section 501(c)(3) organizations in a manner consistent with the IRS ruling.

Charitable organizations, large or small, remain eligible to provide downpayment assistance to FHA mortgagors, subject to meeting the requirements of § 203.19, as proposed to be revised by this rule. HUD's proposed rule does not preclude gifts from charitable organizations that provide housing assistance in a manner that is consistent with operation for exclusively charitable purposes.

Accordingly, the undersigned certifies that this rule will not have a significant economic impact on a substantial number of small entities.

Notwithstanding this determination, small entities are specifically invited to comment on whether this proposed rule will significantly affect them, and to make any recommendations on alternatives for compliance with the requirements of this rule. Comments should be submitted in accordance with the instructions in the **DATES** and **ADDRESSES** sections in the preamble of this proposed rule.

Executive Order 12612, Federalism

The General Counsel, as the Designated Official under section 6(a) of Executive Order 12612, *Federalism*, has determined that this proposed rule would not have “federalism implications” because it does not have substantial direct effects on the states (including their political subdivisions), or on the distribution of power and responsibilities among the various levels of government. This proposed rule solely addresses requirements under HUD’s FHA mortgage insurance programs.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4, approved March 22, 1995) established requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and the private sector. This proposed rule does not impose any federal mandates on any state, local, or tribal governments or the private sector within the meaning of the Unfunded Mandates Reform Act of 1995.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance Number for the principal FHA single-family mortgage insurance program is 14.117. This proposed rule would also apply through cross-referencing to FHA mortgage insurance for condominium units (14.133), and other smaller single-family programs.

List of Subjects in 24 CFR Part 203

Loan programs—housing and community development, Mortgage

insurance, Reporting and recordkeeping requirements.

Accordingly, the Department proposes to amend 24 CFR part 203, as follows:

PART 203—SINGLE FAMILY MORTGAGE INSURANCE

1. The authority citation for part 203 continues to read:

Authority: 12 U.S.C. 1709, 1710, 1715b, 1715z–16, and 1715u; 42 U.S.C. 3535(d).

2. Section 203.19 is revised to read as follows:

§ 203.19 Mortgagor’s investment in the property.

(a) *Required funds.* The mortgagor must have available funds equal to the difference between:

(1) The cost of acquisition, which is the sum of the purchase price of the home and settlement costs acceptable to the Secretary; and

(2) The amount of the insured mortgage.

(b) *Mortgagor’s minimum cash investment.* The required funds under paragraph (a) of this section must include an investment in the property by the mortgagor, in cash or cash equivalent, equal to at least 3 percent of the cost of acquisition as determined by the Secretary, unless the mortgagor is:

(1) A veteran meeting the requirements of § 203.18(b); or

(2) A disaster victim meeting the requirements of § 203.18(e).

(c) *Restrictions on seller funding.* Notwithstanding paragraphs (e) and (f) of this section, the funds required by paragraph (a) of this section shall not consist, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale:

(1) The seller or any other person or entity that financially benefits from the transaction; or

(2) Any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in paragraph (c)(1) of this section.

(d) *Gifts and loans usually prohibited for minimum cash investment.* A

mortgagor may not use funds for any part of the minimum cash investment under paragraph (b) of this section if the funds were obtained through a loan or a gift from any person, except as provided in paragraphs (e) and (f) of this section, respectively.

(e) *Permissible sources of loans.*

(1) *Statutory authorization needed.* A statute must authorize a loan as a source of the mortgagor’s minimum cash investment under paragraph (b) of this section.

(2) *Examples.* The following loans are authorized by statute as a source for the minimum investment:

(i) A loan from a family member, a loan to a mortgagor who is at least 60 years old when the mortgage is accepted for insurance, or a loan that is otherwise expressly authorized by section 203(b)(9) of the National Housing Act;

(ii) A loan made or held by, or insured by, a federal, state, or local government agency or instrumentality under terms and conditions approved by the Secretary; and

(iii) A federal disaster relief loan.

(f) *Permissible sources of gifts.* The following are permissible sources of gifts or grants used for the mortgagor’s minimum investment under paragraph (b) of this section:

(1) Family members and governmental agencies and instrumentalities eligible under paragraphs (e)(2)(i) and (ii) of this section;

(2) An employer or labor union of the mortgagor;

(3) Charitable organizations exempt from taxation under section 501(a), pursuant to section 501(c)(3) of the Internal Revenue Code of 1986, subject to paragraph (c) of this section;

(4) Disaster relief grants; and

(5) Other sources as may be approved by the Secretary on a case-by-case basis.

Dated: April 13, 2007.

Brian D. Montgomery,
Assistant Secretary for Housing-Federal Housing Commissioner.

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