OFFICE OF
CONSUMER CREDIT
COMMISSIONER

LESLIE L. PETTIJOHN
Commissioner

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Interpretation Request Numbers
95-1 and 95-2

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You have requested a review of Consumer Credit Commissioner Interpretation Letter 86-6 and the issues surrounding the filing of an unenforceable lien on a borrower's homestead in Texas. Specifically you seek an interpretation that the *Texas Credit Code* allows the filing of an unenforceable lien on a borrower's homestead in connection with a loan and, if permissible, a clarification of which chapter of the *Texas Credit Code* would govern such a loan. The purpose of filing an unenforceable lien would be to permit the borrower to classify interest on the loan as "qualified residence interest" thereby purporting to make the interest tax deductible under the *Internal Revenue Code*. This same question was addressed in Interpretation Letter 86-6, which concluded that this practice was not authorized and could be a deceptive trade practice.

The introduction of this analysis must begin with the fact that the Texas Constitution prohibits liens on a homestead in Texas except for a permissible purpose. See Texas Constitution, art. 16, § 50, and *Texas Property Code*, § 41.002. These permissible purposes are identified as purchase money, certain taxes, an owelty of partition, and for work and material used in constructing improvements.

The *Tax Reform Act* of 1986 amended the *Internal Revenue Code* to provide that, subject to a phase-in period, personal interest is not deductible, except for "qualified residence interest." The *Tax Reform Act* prompted a number of lenders in 1986 to seek an interpretation that "they may make loans under existing Texas Constitution and statutes

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which would give the debtor fully deductible 'qualified residence interest' by virtue of a 'lien' on a homestead" (Interpretation Letter 86-6). Interpretation Letter 86-6, issued by a former commissioner, found that such loans could not be made legally under the *Texas Credit Code*. Based upon a 1988 amendment to the *Internal Revenue Code* you have requested that I re-examine Interpretation 86-6. Rather than amending Interpretation Letter 86-6 I have elected to withdraw that letter and take a new look at the relevant issues under the *Texas Credit Code*.

## REAL ESTATE LIENS AND THE *TEXAS CREDIT CODE*

Unless otherwise fixed by law, art. 16 § 11 of the Texas Constitution limits interest rates in written agreements to 10% per annum. The Texas Legislature enacted the *Texas Credit Code* in 1967 to authorize interest rates higher than 10%, subject to certain consumer protections. Chapters 3 and 4 of the *Texas Credit Code* authorize higher interest rates on smaller loans regulated by the state through licensing and the examination of lenders. Chapter 5 authorizes higher rates on loans secured by a second or other inferior lien on real property improved by a one-to-four family dwelling, again subject to regulation by the state.

The Legislature amended the *Texas Credit Code* in 1981 to authorize a rate of at least 18% per annum under art. 1.04. The 18% rate was authorized as an alternative under Chapters 4, 5, and 15. In addition to increasing the maximum rate, art. 1.04 also required certain persons charging these higher rates to be licensed under the provisions of Chapter 3 and to comply with the provisions of arts. 104(n)(1), 1.04(n)(2), and Chapters 3, 4, 5, and 15, as applicable. The Legislature was intent on preserving and reinforcing the safeguards and consumer protections provided in Chapters 3, 4, 5, and 15, while at the same time authorizing a higher rate of return for creditors.

The 1981 amendments also authorize the Consumer Credit Commissioner to issue interpretations of the *Texas Credit Code* that grant safe harbor protection to creditors. An interested party in this interpretation, while recognizing the intent of the Legislature that resulted in the aforementioned provisions of law, opined:

> "...with the advent of interest rate reform in Texas in 1981, which authorized an 18% usury minimum/maximum and a 24% - 28% usury maximum/maximum, much of the historical basis for Chapter 5 and the strict structure under which Texas lenders achieved exemptions from the 10% usury maximum has become anachronistic."

I will not debate the merits of Chapter 5, but merely emphasize that at the same time the Legislature was allowing an 18% rate in Chapters 4 and 5 it required a lender using those rates to be licensed under the provisions of Chapter 3 and be subject to Chapter 4 and Chapter 5. Whether the "strict structure" of the law is or is not "anachronistic," it is the law that the Legislature provided us and the law that provides the Consumer Credit Commissioner with the authority to issue interpretations of Title 79. The *Texas Credit Code*, however, does not authorize the Consumer Credit Commissioner to change any law enacted by the Legislature. It has always been the position of this office that no agency may expand the law or legislate by administrative interpretation in the absence of clear legislative intent.

Chapter 5 of the *Texas Credit Code* requires a loan subject to its provisions to be secured by a lien on real estate. See art. 1.04(n)(2) and art. 5.01(1). A loan in which a borrower executes and records an unenforceable lien against the borrower's homestead is not "secured" for purposes of Chapter 5 of the *Texas Credit Code* and, therefore, cannot be made under the authority of Chapter 5.

Chapters 3, 4, and 15 each prohibit a lender from taking a lien on real estate as security for a loan. See art. 3.20(2), art. 4.04(2), and art. 15.07. I have received advice that, in actuality, the lender is not taking a lien upon real estate "as security" for a loan even though the borrower executes a lien before a notary public that is then filed in the county real property records. The argument is that since the lien is proposed to be unenforceable, it does not serve "as security" for the loan. I, however, cannot decide such an important issue as this on the basis of semantics. Because of the ambiguity of the statutory language as it relates to the taking of a lien upon real estate for any loan made under Chapters 3, 4, and 15, I decline to attempt a cure to this dilemma by administrative interpretation. My action should not be interpreted, however, in any way as an impediment or a contrary view by either the courts of this state or the Legislature.

The Legislature has toiled with the fundamental philosophy of Texas homestead protection for a number of sessions. This issue will, in all probability, be revisited in the next legislative session. Perhaps if the Legislature revisits these issues a change may evolve. As I have said, though, this is a matter of consideration by the Legislature and not a cure that I can enact by administrative interpretation. As a result, I decline to issue a safe harbor interpretation that such transactions are permissible under Chapters 1, 3, 4, or 15 of the *Texas Credit Code*.

## THE *TEXAS DECEPTIVE TRADE PRACTICES ACT*

The former commissioner gave weight to the provisions of the *Deceptive Trade Practices Act* (*DTPA*), as found in § 17.46 of the *Business and Commerce Code* in Interpretation Letter 86-6. That interpretation also recognized that Chapter 1 is silent as to any language dealing with liens or collateral. It further found that loans which involve real estate lien documents purporting to place a lien against a homestead even when the same document or other forms notify the borrower that the lien is invalid should not be made under Chapter 1. This finding was based upon an interpretation of the *Deceptive Trade Practices Act*. I find, however, that I do not have authority to interpret the *DTPA*, because any interpretive authority under art. 1.04(p), art. 2.02A(10), and art. 2.08(5) is limited to Title 79.

## THE *INTERNAL REVENUE CODE*

The renewed interest in this issue has resulted from an amendment of the *Internal Revenue Code* in 1988 that was designed in an attempt to allow a loan to be treated as secured by a homestead in Texas in order to treat the interest as qualified residence interest. One of the requesters for this interpretation of the relationship of the *Internal Revenue Code* (*IRC*) and the *Texas Credit Code* is assured that Congress, by its amendments to the *IRC*, has preempted the *Texas Credit Code*, thereby removing any impediment to Texans securing a qualified residence interest deduction. As I have found in my discussion above of the *DTPA*, and as the former commissioner did in Interpretation Letters 92-2, 94-2, and 94-3, I decline to issue an interpretation of federal law.

## SUMMARY

Interpretation Letter 86-6 relied upon an interpretation of the *Texas Deceptive Trade Practices Act*, the *Internal Revenue Code*, *Texas Credit Code*, Texas Constitution, and Texas property laws and is hereby withdrawn. The issue of the executing and recording of an unenforceable lien by a borrower on their homestead is not contemplated in the enactment of Texas credit laws. The ability to establish this "lien" is important only to establish whether the interest on a loan is "qualified residence interest" as defined in the *Internal Revenue Code*. This definition and its treatment is extraneous to compliance issues under the *Texas Credit Code*. The propriety of creating an unenforceable lien and "securing" a loan is a question outside of the scope of Title 79. This practice is clearly prohibited as a Chapter 5 loan, since a lien under Chapter 5 requires a secured interest in real property.

Notwithstanding the express prohibition for taking a lien on real estate in Chapters 3, 4, or 15, no other express prohibition or permission exists in Chapters 1, 3, 4, or 15 to authorize or impede lenders and borrowers from structuring this type of transaction. I decline to interpret the statute to permit this practice, and in effect, legislate by administrative interpretation.

Sincerely,

Leslie L. Pettijohn
Commissioner

Approved by the Finance Commission February 9, 1996