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STATE OF TEXAS

OFFICE OF CONSUMER CREDIT COMMISSIONER

AL ENDSLEY, Commissioner

2601 NORTH LAMAR
AUSTIN, TEXAS 78705-4207

(512)479-1280
(214)263-2016
(713)461-4074

Writer's Direct Number: 479 1292

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Ms. Sharon Lock Davis
First Texas Savings Association
1431 Greenway Drive, Suite 700
Irving, Texas 75038

Dear Ms. Davis:

You have requested an interpretation by this office concerning questions presented by the enactment of the Tax Reform Act as it is affected by Texas law. Congress has amended the Internal Revenue Code to phase out over a five year period the deduction for interest paid on consumer loans, credit cards, etc. Beginning in 1987 "qualified residence interest" will be fully deductible. Qualified residence interest means interest on debt secured by a security interest perfected under local law on a taxpayer's principal or second residence (subject to certain limitations).

Several people who have contacted us have asserted that Senator Lloyd Bentsen caused certain language to be included in the Tax Reform Act providing specific recognition of the problem in Texas with liens on homesteads and/or authorizing "qualified residence interest" loans to be secured by a homestead in Texas. It is my understanding that there is, in fact, no provision in the legislation dealing with Texas. The principal provisions are as follows:

> "The term 'qualified residence interest' means interest which is paid or accrued during the taxable year on indebtedness which is secured by any property which (at the time such interest is paid or accrued) is a qualified residence of the taxpayer."
>
> "The term 'qualified residence' means-
>
> > "(I) the principal residence (within the meaning of section 1034) of the taxpayer, and
> >
> > "(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1))."

The following are excerpts from the Conference Committee Report and the Congressional Record which mention the Texas situations:

> "In addition, it is intended that the fact that State homestead laws may restrict the rights of secured parties with respect to certain types of residential mortgages will not cause interest on the debt to be treated as nondeductible personal interest, provided the lender's security interest is perfected and provided the interest on the debt is otherwise qualified residence interest."

> "I have spoken with Mr. Pickle and he is concerned about the treatment of interest on a loan which is secured by a recorded deed of trust, mortgage or other security interest in a taxpayer's principal or second residence, in a State such as Texas, where the enforceability of such recorded security instrument will be restricted by State and local laws, such as the Texas homestead law. Under section 1421 of H.R. 3838, such interest is treated as qualified residence interest, provided the interest on the debt is otherwise qualified residence interest."

Based on the situation described above we have a number of lenders seeking an interpretation that they may make loans under existing Texas Constitution and statutes which would give the debtor fully deductible "qualified residence interest" by virtue of a "lien" on a homestead. To address the Federal tax statute and the pertinent state provisions, the lender must take a lien in order to provide for tax deductible interest and then repudiate the lien in order to avoid state problems. We find the following in the Tax Code in defining deductible interest: "...interest...on indebtedness which is secured by any property...." Also please take note of the underlined language in the Conference Committee Report and Congressional Record above regarding recording and perfecting liens. When we look to the Texas Constitution we do not find a prohibition against taking a lien but the following language regarding the validity of the lien.

> "Sec. 50. The homestead of a family shall be, and is hereby protected from forced sale, for the payment of all debts except for the purchase money thereof, or a part of such purchase money, the taxes due thereon, or for work and material used in constructing improvements thereon, and in this last case only when the work and material are contracted for in writing, with the consent of the wife given in the same manner as is required in making a sale and conveyance of the homestead; nor shall the owner, if a married man, sell the homestead without the consent of the wife, given in such manner as may be prescribed by law. No mortgage, trust deed, or other lien on the homestead shall ever be valid, except for the purchase money therefor, or improvements made thereon, as hereinbefore provided, whether such mortgage, or trust deed, or other lien, shall have been created by the husband alone, or together with his wife; and all pretended sales of the homestead involving any condition of defeasance shall be void."

Then in the Property Code, Section 41.002 we find the following similar provisions:

> "(a) A homestead and one or more lots held for use as a sepulcher of a family or a single adult who is not a member of a family are exempt from attachment, execution, and forced sale for the payment of debts, except for encumbrances properly fixed on the property.
>
> "(b) The proceeds of a voluntary sale of a homestead are not subject to garnishment or forced sale before six months after the date of the sale.
>
> "(c) The homestead exemption provided in this section does not apply if the debt is for:
>
> > "(1) all or part of the purchase money of the homestead;
> > "(2) taxes on the homestead; or
> > "(3) work and material used in constructing improvements on the homestead, if the work and material have been contracted for in writing and, in the case of a family homestead, if both spouses have given consent in the manner required by law for the conveyance of the homestead."

To have any chance at an interest deduction it appears that a lender must take and file a deed of trust or other document which purports to create a lien on the borrower's homestead even though the lien is void, voidable or unenforceable. Section 17.46 of the Business and Commerce Code casts doubt as to the legality of the action even though lenders may disclose to the borrower on the deed of trust that the purported lien is invalid even though it is filed with the County Clerk in an effort to meet the Federal "perfection" requirements. The pertinent provisions of Section 17.46 read as follows:

> "(a) False, misleading, or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful and are subject to action by the consumer protection division under Sections 17.47, 17.58, 17.60 and 17.61 of this code.
>
> "(b) Except as provided in Subsection (d) of this section, the term 'false, misleading, or deceptive acts or practices' includes, but is not limited to, the following acts:
>
> > ...
> > "(5) representing that goods or services have sponsorship, approval, characteristics, ingredients, uses, benefits, or quantities which they do not have
> > ...
> > "(12) representing that an agreement confers or involves rights, remedies, or obligations which it does not have or involve, or which are prohibited by law;...."

You have asked us if a non-purchase money equity loan secured by the taxpayer's homestead could be made under the provisions of Article 5069, Vernon's Texas Civil Statutes, The Texas Credit Code.

Your inquiry, dated October 27th, was the first of several we have received addressing the homestead/credit issues you have presented. We will, accordingly, attempt to incorporate within our answers to your questions a general answer to all of the questions presented.

Art. 5069, V.T.C.S. was enacted by the Texas Legislature as a compilation of laws governing loans and credit sales and the finance charges which may be charged in connection therewith. Five chapters of the Code, Chapters 1, 3, 4, 5 and 15, are applicable when discussing the questions presented by your inquiry.

Art. 1.04(a) found in Chapter 1 provides that parties may agree to and stipulate for any rate of interest provided by that section on any written contract.

Art. 1.04(n)(1) provides that any loan made under the authority of Art. 1.04 that is extended either primarily for personal, family or household use or primarily for the purchase of a motor vehicle, and that is payable in two or more installments, not secured by a lien on real estate, and that is entered by a person engaged in the business of making or negotiating those types of loans, is subject to Chapter 4.

Art. 1.04(n)(2) provides that any loan made under the authority of Art. 1.04 that is extended either primarily for personal, family or household use is subject to the provisions of Chapter 5, if such loan is predominantly payable in monthly installments and is described by Article 5.01(1) and made, negotiated or arranged by a person engaged in the business of making, negotiating or arranging those types of loans.

As noted by the underlined description of Art. 1.04(n)(1), any loan which would otherwise be subject to the provisions of Chapter 4 is exempted from such provisions if such loan is secured by a lien on real estate.

Art. 5.01(1) defines a "secondary mortgage loan" as that term is used in Chapter 5 as "a loan made to any person not to be repaid in ninety days or less which is secured, in whole or in part, by any lien or security interest or any interest in real property improved by a dwelling designed for occupancy by four families or less, which property is subject to the lien of one or more liens or security interests, prior mortgages or deeds of trust...."

The Declaration of Legislative Intent in the 1967 enactment of the Texas Credit Code indicates the Legislature sought to regulate loans and lenders, to protect the citizens of Texas from abusive and deceptive practices and serve the public interest of the people of the State.

From the statutory provisions cited above as well as from Chapter 3 it is evident that a loan that is extended either primarily for personal, family or household use and that is payable in two or more installments and that is made by a person engaged in the business of making or negotiating those types of loans is subject to the provisions of Chapter 3, Chapter 4 or Chapter 5 of the Code.

If a loan purporting, for tax purposes, to be secured by a homestead is "secured" by real estate as defined in Chapter 5 then said Chapter would govern such a loan. We have since the enactment of Chapter 5 in 1967 taken the position that "secured" meant that the lender held a valid, enforceable lien on appropriate real property. I find no reasonable, logical reason to change our position. I, therefore, find loans involving purported liens on homesteads may not be made pursuant to Chapter 5.

Can a lender then make a loan with a purported lien on a homestead pursuant to Chapters 3, 4 or 15? Art. 3.20(2) and Art. 4.04(2) provide that "No lender shall take a lien upon real estate as security for any loan made under this Chapter,...." Art. 15.07 in Chapter 15 restricts collateral to that permitted by Chapter 4. While the argument is put forward that there is really no lien on the homestead, it is not unreasonable to believe that the legislature intended that no real estate lien documents be executed in connection with the making of a Chapter 3 or 4 loan. Should the issue have arisen in 1967 of the propriety of taking real estate lien documents on a homestead in connection with a loan made under the Credit Code I believe the Legislature would have expressly declared such acts a deceptive practice or otherwise prohibited it. While this whole issue has arisen out of the desire to maximize income tax deductions, and I am certainly not opposed to that, the tax issue itself is extraneous. I find that a lender cannot lawfully make a loan with a purported lien on a homestead pursuant to Chapters 3, 4 or 15.

We are left with the question of the legality of making the loan under Chapter 1. This chapter does not contain any language dealing with liens or collateral as it relates to this issue except as previously mentioned. I believe that the aforementioned language of the Declaration of Legislative Intent and the above quoted provisions of the Deceptive Trade Practices Act offer sufficient basis to rule that loans should not be made under Chapter 1 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. It appears that there is a fundamental lack of "truth in lending" in such a transaction and the unsophisticated borrower has no assurance of what is "right."

I trust that this reply is adequate as to your questions. If not, please feel free to contact me.

Sincerely,

Al Endsley
Commissioner