Shake-Down Payment

By Reg P. Wydeven
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For many, the American Dream would be to pull your minivan into the driveway of your own residence, surrounded by a white picket fence with an apple pie cooling on the kitchen windowsill.

Because of low interest rates, many families that never owned homes before are now living in their own houses. Several of these families took advantage of down-payment assistance programs to help them buy their first house. A recent ruling by the IRS, however, has closed the door on many of these programs.

To qualify for a mortgage insured by the Federal Housing Administration, first-time or low-income purchasers must come up with a down-payment for the house, typically 20% of the purchase price. If the buyers can't come up with the 20%, they are required to have private mortgage insurance, which covers the lender in the event the buyers can't make their payments. While extremely helpful, private mortgage insurance is expensive, and adds to an already high monthly payment.

To get around the PMI requirement, home buyers are able to receive assistance with the down-payment from relatives, an employer or a charity. Buyers can't, however, receive assistance directly from home sellers.

To help families live out the American dream, many charities were organized to help them come up with a down-payment for a house. Funded by churches or other not-for-profit entities, these charities have helped millions of Americans purchase homes.

According to the Government Accountability Office, in 2000, 5.8% of FHA single-family mortgages used down-payment assistance from a charity. In 2004, this number skyrocketed to 31%. While most of these charities are legitimate organizations that raised funds to help families buy homes, some are merely fronts for other for-profit businesses. Instead of using non-profit fundraising, these outfits were simply being reimbursed by home sellers.

For example, if a young family was unable to come up with a down-payment for an $80,000 house they fell in love with, the down-payment assistance companies would instruct the buyer to offer $100,000 for the house. In the offer, the seller would be required to make a $20,000 tax-deductible "donation" to the company, which it would then, in turn, give to the buyers to use for their down-payment.

The down-payment assistance company customarily charges a hefty fee for helping finance the purchase. These companies claim that the buyers got their dream house and the sellers got the $80,000 they were asking, so everyone wins, right? Well, the IRS doesn't think so.

The problem arises when the buyers decide they want to buy a new home or refinance their existing loan. They are often very upset when they go to sell or refinance a home they 'paid' $100,000 for that is only worth $80,000.

Secondly, if the home was not the sellers' principal residence, they received a 1099-S reporting the sale of a $100,000 house that they only cleared $80,000 for. The IRS would expect capital gains taxes to be paid on the phantom $20,000. In addition, many closing fees would increase because of the inflated purchase price, including title insurance premiums and transfer fees.

The IRS's ruling revoked the tax-exempt status of these charities because the true benefits of the program are going to for-profit entities. For some, the American Dream has become a nightmare.