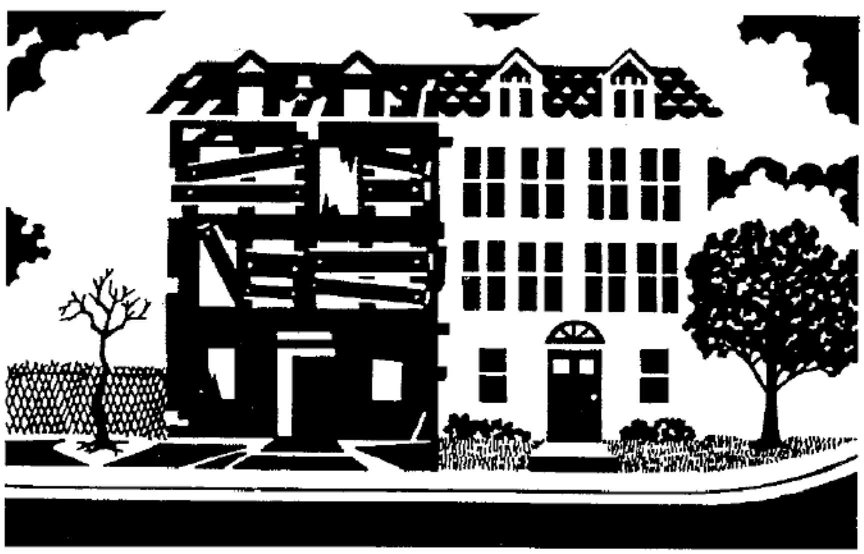
Homeownership Options Under the HOME Program

A MODEL FOR PUBLICLY HELD PROPERTIES AND LAND TRUSTS



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Contents

Chapter Three

Using HOME with Land Trusts

The cost of land is a significant component of the budget for affordable housing. Land can be 20 to 30 percent of a housing unit's total development cost, particularly for single family housing. In rising markets, speculation and rising land prices tend to drive up housing prices faster than the cost of construction.

By removing the land from the speculative market, the increase in the cost of the housing over time can be moderated. This is the primary reason land trusts are becoming an increasingly significant mechanism for developing and preserving affordable housing. Land trusts are entities, usually nonprofits, created to hold land for the community or individuals within the community. While the land trust owns the land, the occupant or user of the property owns the improvements on the land, such as a house. By separating out or eliminating the land cost, the capital requirements are reduced, and the housing can be made more affordable.

Land trusts have been used historically for conserving properties for public use or environmental protection – including agricultural land, forests, beaches, gardens, historic sites, and environmentally sensitive areas. Trusts have also been used for many decades for ownership of commercial land; many well-known properties in Manhattan and other urban communities sit on land that is leased. But as a mechanism for affordable housing, land trusts have come into widespread use only in the last two decades.

Beginning in the 1960's, groups such as the Institute for Community Economics promoted Community Land Trusts (land trusts) as a community mechanism for providing and maintaining affordable housing. The oldest operating land trusts date to the mid-1970s, but the proliferation of land trusts began in the 1980s and has continued to the present time. Today, land trusts exist nationwide, thriving in both urban and rural areas, and in all kinds of housing market settings. Land trusts have been used primarily for affordable homeownership, but they have been used for rental housing in certain circumstances.

LAND TRUSTS DEFINED

For the purposes of this guide, land trusts shall refer to community-based nonprofit organizations that are created to acquire land and remove it from the speculative market. The land is made available to families, cooperatives and other organizations under long-term leases. Their members and boards include households who lease land from the trust.

Not all land trusts fit this description. Some private nonprofits serve similar land trust functions. However, nearly all land trusts focusing on affordable housing, whether community-based or private, are structured as nonprofit corporations rather than as public entities. With Internal Revenue Service 501(c)(3) status, a nonprofit trust can reach beyond the public sources of funds (such as the HOME Program) to raise money from charitable foundations and to solicit contributions of land from private individuals (who receive tax deductions for their charitable contributions in lieu of sales proceeds). If a public agency acts as the land trust, it is subject to public laws regarding acquisition of property, it assumes the uncomfortable dual roles of landlord as well as tax collector, and it is exposed to the liabilities of land ownership. For all these reasons, land trusts tend to be nonprofit entities.

In cases where the long-term goal is to build a portfolio of land held in trust, a separate land trust entity is created. However, if the land trust is a single-purpose device for a specific property, a separate legal entity may not be cost effective, and a standing nonprofit organization can serve as the land trust.

Key Land Trust Terms

Lessor: The land trust

Lessee: The household, cooperative, or other entity that leases the land from the land trust.

Ground lease: The legal document giving the lessee the right to occupy and use the property.

Leasehold interests: The rights to use and occupancy of the property that are conveyed via the ground lease.

THE HOME PROGRAM AND LAND TRUSTS

HOME funds may be used for land trust activities that produce eligible low-income housing. In fact, the HOME Statute promoted the use of community land trusts for Community Housing Development Organization (CHDO) activities.

HOME funds may be used to purchase the land to be held by a land trust for rental or homeownership use that meets the requirements of HOME. Bear in mind that HOME funds may not be used to compensate the PJ for property it owns (as discussed in Chapter 1), nor can it be used to purchase property and hold it for future development (also called "land banking"). The land must be put into use as low-income housing. Jurisdictions should fund land trust acquisitions only when there are feasible and immediate plans for producing eligible low-income housing on the property.

A land trust can qualify as a CHDO provided it meets the board and other requirements of the HOME Program. In addition, to be eligible for CHDO funds, the land trust must play an active development role commensurate with the "own, develop or sponsor" requirements of CHDO-eligible activities. Acquisition and holding of title to the land on which someone else develops and owns the improvements is unlikely to qualify as a CHDO activity. However, whether or not the land trust qualifies as a CHDO, it may use other HOME funds for HOME-eligible activities.

One advantage of a land trust is that properties donated or sold at discounted prices to a nonprofit land trust are eligible to be considered as matching funds under 92.220(a)(3) of the HOME Final Rule.

Community land trusts may be particularly useful in serving communities with high or rapidly appreciating real estate values. Properties that exceed the HOME limit of 95 percent of median value (see 92.254(a)(2)) are not eligible for owner-occupied rehabilitation or homebuyer assistance with HOME funds. However, if the underlying land was placed in a land trust, and only the improvements were conveyed to the buyer, the price or value (after-rehabilitation) of the improvements might fall within this statutory limit. Consider the following example:

PJ's 95% of median sales price limit (FHA 203(b) limit)	$170,000
Property value/price	$190,000
Land value	$50,000
Building value	$140,000

At first glance, it would appear that the property in the example above is not eligible under HOME Program guidelines if both the land and improvements were sold, even if the financing package could make it affordable to an eligible low-income buyer. However, if only the building is sold to the low-income buyer while the land is held in trust, the property could meet the HOME price/value limit. (Of course, the acquisition would still have to be made affordable to the low-income buyer.)

HOME occupancy and affordability restrictions may be imposed through the ground lease, provided the land trust mechanism has been incorporated into the PJ's Consolidated Plan and approved by HUD as an allowable form of homeownership.

HOW A LAND TRUST PURCHASE WORKS

A land trust purchases or receives title to a property. If the property contains buildings ("improvements") or a building is developed after acquisition, the title to the improvements is conveyed to an owner along with a long-term ground lease. Sometimes a land trust also acts as developer, creating or rehabilitating the housing to be conveyed to eligible buyers. This developer role, however, can be played by others, and is not considered a defining role of the land trust (unless the land trust project is to be qualified for CHDO funds).

The ground lease is not the typical rental lease that provides for year-to-year occupancy. Instead, it gives the lessee the right to occupy the property for a very long period of time, perhaps 99 years. The lessee can continue to occupy the property (and often can extend the period one or more additional terms) by complying with the use restrictions, paying required rent, and maintaining the property.

Sometimes the ground rent that is charged the lessee is a nominal amount to cover the costs incurred by the land trust for any land acquisition debt, insurance, taxes and administrative costs. (If the trust borrows funds to purchase the property, it retains responsibility for making debt service payments on its borrowings, and the lease payments should reflect these debt service costs.) This is often the case in affordable housing projects. In other cases, the ground rent reflects a market value.

The buyer/owner of the improvements borrows money from lenders just as any other property owner, except that there is an assignment of the leasehold interests to the lender along with a mortgage on the improvements. (Some lenders may insist upon a mortgage on the land that includes the ability to foreclose upon the property, not just assignment of the leasehold interests. See When Things Go Wrong below.) Any future borrowings against the property, including refinancing, typically require the approval of the land trust to ensure its interests are protected.

The lessee is responsible for maintenance of the property and improvements. The land trust collects the monthly (or annual) ground lease payments, and uses the revenue to pay insurance, taxes and other costs of property ownership. Tax payments may be jointly escrowed or paid with the lessee's portion of the taxes or paid separately, depending on local requirements or the need to monitor lessee payments.

On resale, the land trust usually has certain rights to control or influence the sale, as outlined below in Maintaining Affordability.

What's in a Ground Lease?

A ground lease is a legal document disclosing all aspects of the arrangement between the lessor and lessee, and typically includes the following clauses:

- The term of lease and options to extend the lease;
- The ground rent or lease fees, and basis for future increases;
- Payment of taxes and insurance by the lessor and lessee;
- Permitted uses of the premises;
- Ownership of the improvements;
- Maintenance of the premises;
- Liability and indemnification of the lessor;
- Limitations on mortgages and refinancing;
- Ongoing compliance and access to lessor;
- Mortgage defaults and foreclosure provisions;
- The lessor's right to purchase;
- Assignment, transfer or sale of improvements; and
- Dispute resolution and termination.

Maintaining Affordability

In addition to isolating the land from speculative market forces and moderating the future price rises in the housing, some land trusts use the ground lease as a legal device to ensure ongoing low-income occupancy and preserve affordability. For example, the ground lease can contain one or more of the following clauses:

- Continued use for homeownership, or required land trust approval of subleases;
- Adjustment of the ground rent to full market price if affordability is not maintained;
- Land trust approval of all mortgages placed on the property;
- Right of first refusal for the land trust to purchase the home if the lessee chooses to sell;
- Limited equity policies or formulas that restrict the resale price;
- Land trust approval of the new homebuyer (and lessee), including income eligibility limits on the new lessee; and
- Other means of ensuring continued use of the property for affordable housing.

With any of these additional restrictions in place, owners can still earn a fair return on their portion of the housing investment, but the appreciation of the land value accrues to the land trust. Future buyers will find the housing more affordable because they do not have to pay for the appreciating land value.

Burlington Community Land Trust

The city of Burlington, Vermont has a resident population of about 40,000 and is home to two colleges and the main campus of the state university, thereby hosting approximately 10,000 additional residents when school is in session. During the 1980's, Burlington experienced a significant economic boom which increased development pressures on existing housing units and encouraged real estate speculation in the city. The effects of the economic boom combined with the competitive rental market to double rents between 1980 and 1985 and create a one percent vacancy rate in 1985. Real estate in Burlington was appreciating much faster than the median income of its residents, threatening the affordability of housing for many residents of the city.

In June of 1983, the City of Burlington responded to the worsening housing situation by appropriating $200,000 in seed money for the creation of a community land trust. The Burlington Community Land Trust (Bland trust) was incorporated in April 1984 and began by leveraging the City's original allocation in order to acquire and rehabilitate rental properties in the city's Old North End. By 1993, Bland trust's holdings totaled approximately 200 residential units throughout the city. The Bland trust soon found that managing a large pool of rental housing was demanding, and decided to relieve itself of the burden of property management. Ultimately, the tenants of many Bland trust multi-family properties organized to form cooperatives and purchase their buildings from the Bland trust. When the conversion process was completed, the cooperatives leased the land from the Bland trust while owning the buildings on that land.

The City's Housing Program Administrator described five main benefits of the Bland trust, and the community land trust model as a whole: 1) retention of public subsidies as a result of continued land ownership; 2) the ability to rehabilitate, upgrade, and/or develop property without economically displacing residents; 3) the effect of land trust properties in stabilizing housing costs without a municipal ordinance; 4) grassroots neighborhood protection and open space planning; and 5) the return of property to the tax rolls while still being used for a public purpose. In addition, the Housing Program Administrator suggested that an increase in relative buying power in the community might be attributable to land trust activities, as the percentage of household income dedicated to housing costs decreases.

Source: Institute for Community Economics, *Profiles of Community Land Trusts*. January 1993.

Ground Leases and Affordable Rental Housing

The predominant use of land trusts has been for affordable homeownership, since land trusts can reduce the amount of financing that must be carried by low-income buyers. However, the land trust mechanism may also be used for rental housing, particularly where there is an interest in controlling the property for long-term affordability. Through a ground lease, a land trust can limit the resale of the property and ensure that the current and future owners continue to provide affordable housing. Provisions in the ground lease assert restrictions on assignment to other lessees.

The financial impact of the land trust mechanism on an individual project is not as significant as it is to homeownership, although it must be handled in a way that does not adversely affect the borrowing capacity of the project. The land acquisition cost can be removed from the development pro forma, reducing the overall development cost to be financed. However, ground lease fees would have to be added to the operating budget. If the ground lease fees are included in the operating expenses, then net operating income is reduced, and consequently the amount of debt that can be serviced. To avoid this impact, ground lease fees would have to be payable out of net cash flow after debt service. To permit this, the land trust would have to be able to absorb related costs if the project were unable to pay.

In projects using Low-Income Housing Tax Credits (LIHTC), the retention of land ownership by the land trust reduces the overall development cost, but does not affect adversely the eligible basis or the calculation of tax credits. Land is ineligible for basis, so the cost of the land would not be included in any event. Furthermore, HOME funds could be used by the land trust for acquisition, without affecting the eligibility of the project for the nine percent credit. (See *Using HOME with Tax Credits*, another HUD model guide in this series).

When Things Go Wrong

Land trusts are an attractive mechanism for increasing and preserving affordable housing. So what can go wrong?

As noted above, there is risk associated with advancing HOME funds for acquisition. If the project fails to be completed, the HOME funds must be repaid. Jurisdictions should advance funds for acquisition only after a full development plan is in place.

In addition, there are the several risks of non-performance or default by the lessee:

- ❑ Failure to pay ground lease fees -- The owner could fail to make ground lease payments, leaving the land trust without revenue to pay taxes, insurance and debt service (if applicable). It is likely that ground rent will be one of the first things not to be paid by a lessee who encounters financial difficulties.

- ❑ Failure to comply with HOME requirements -- The owner could fail to comply with HOME requirements, such as subletting the unit without land trust consent. Enforcement mechanisms are limited, and may result in legal action and eviction.

- ❑ Failure to maintain premises -- The owner may fail to maintain the premises, causing a neighborhood blight rather than an improvement, and leaving the land trust with an image problem. Enforcement actions again are not always satisfactory, with the land trust forcing the owner to maintain or incurring the costs to maintain.

- ❑ Tax delinquency -- An owner can fall behind on real estate tax payments, putting the property at jeopardy of tax foreclosure.

- ❑ Mortgage default and foreclosure -- The owner could default on mortgage payments, and put the property in jeopardy of foreclosure and sale of the property.

Even when the lessee/owner is compelled to take corrective action, the effort by the land trust to gain compliance is substantial and the outcome is likely to be less than satisfactory. Of course, all these things can occur when HOME funds are lent and no ground lease is in place. The ground lease does not increase or decrease the chances of these defaults. In some respects, a land trust is in a stronger position than a "junior" lender to intervene and to prevent a sale that extinguishes the low-income use restrictions.

If a lender has to foreclose, the improvements and the leasehold interests will be sold. Some lenders will insist on a mortgage on the land that enables them to foreclose and take the land and unify with the improvements for resale. Although this is permitted under HOME rules, land trusts generally try to avoid such liens and negotiate provisions to intervene and work out the project with the lender. (Of course, the land trust may have to be in a position to buy out the lender to preserve the property.) So the land trust mechanism cannot prevent things from going wrong, but as the holder of one piece of the title, the sponsor may be in a better position to work out the problem with the other parties.

Northern Communities Community Land Trust

Duluth, Minnesota suffered dramatically when the American steel industry collapsed during the 1980s. Thousands of jobs were lost when the U.S. Steel plant and complementary industrial facilities closed and the shipments of ore from this port city slowed. More than one-quarter of Duluth's population was lost between 1970 and 1990. Still, Duluth managed to achieve some economic stabilization as a result of expanding educational and medical facilities, tourism and new industrial activities during the 1990s.

Although the real estate market remained depressed during the period of economic recovery, affordable housing was lost to prolonged vacancy, subsequent deterioration, and ultimately condemnation and demolition by the City. Still more housing was being removed from the market by the expansion of medical facilities and transportation infrastructure. Though home purchase prices remained low in Duluth, low-income persons faced the common inability to secure financing through conventional mechanisms. At the same time, low-income persons faced a shrinking supply of rental units while increased competition from college students pushed up rents.

The Northern Communities Land Trust (Nland trust) was incorporated in 1990 to address the housing situation faced by the city's low-income residents – a large number of households paying more than 50 percent of their incomes for inadequate housing and large numbers of homeless people. The low real estate prices and high rent levels in Duluth created an ideal environment for the Nland trust to acquire, rehabilitate, and develop affordable housing in the city. The Nland trust involved a broad range of actors in its effort to provide adequate housing and homeownership opportunities to the low-income residents of Duluth, including local non-profit organizations, hospitals, university groups, the City of Duluth, and other private entities. In fact, the Nland trust included a category for private housing developers on its Board of Directors, along with the more common leaseholder, non-leaseholder, and "larger public interest" categories seen in many land trusts.

Source: Institute for Community Economics, *Profiles of Community Land Trusts*. January 1993.

In conclusion, land trusts are increasingly becoming a vehicle for promoting affordable housing, helping more low-income families to afford homeownership, and helping to ensure long-term affordability in both homeownership and rental properties. HOME funds may be used to fund land trust projects, subject to the limitations noted in this section. Jurisdictions will find this to be a useful tool to add to the affordable housing toolbox.

This guide is not just about land trusts or multifamily homeownership. It is about the challenges and opportunities presented by publicly held properties.

Vacant and abandoned publicly held properties constitute a challenge to PJs, but the HOME Program can offer opportunities to your community to remove the blight and restore those properties to active tax rolls. Chapter 1 of this guide discussed a broad set of options you have under HOME to redevelop these publicly held parcels for the appropriate type of housing, including new infill housing development, and conversion of non-residential properties. Chapter 2 offered guidance on multifamily homeownership as an option to reusing multifamily properties for affordable homeownership, and Chapter 3 has introduced land trusts as a means to achieving affordable housing with HOME and other funding.