Chapter 19
Subsidy Structure

In typical affordable homeownership programs – including those operated by CLTs – the home is purchased with a small down payment and with a major part of the price covered by first mortgage financing with affordable monthly amortization. The amount covered by these financial components, however, is almost always less than either the cost of producing the homeownership unit or the unrestricted market value of the unit. The financial component that fills this gap between what it costs to produce or purchase the unit in the open market and what the homebuyer can afford is what is generally identified as *the subsidy*. The subsidy can derive from a grant or donation of land, materials, labor or money from a charitable source, but, for most projects, the bulk of the subsidy is contributed by government sources in the form of real estate or funding. A major advantage of the CLT approach over other approaches to subsidized homeownership is that the CLT can "lock in" the subsidy, so that the home does not need to be re-subsidized each time it is sold. However, the CLT can lock in subsidies *only* if the subsidies are "structured" in a way that *allows them to be* locked in.

Permanent Vs. Homebuyer-by-Homebuyer Subsidies

In general, subsidies that are disbursed to the CLT itself are locked in as *permanent subsidies* and provide the basis for permanent affordability. Subsidies that are credited to particular homebuyers to create affordability specifically for their home purchases – *homebuyer-by-homebuyer subsidies* – are not locked in and cannot be expected to provide permanent affordability. To the extent possible, CLTs want the subsidies utilized by their programs to be permanent subsidies rather than homebuyer-by-homebuyer subsidies.

Permanent subsidies. Permanent subsidies may be disbursed to the CLT as either grants or deferred loans. When they are treated as grants, the CLT normally signs some form of "subsidy agreement" ensuring that the homes in question will be sold to members of the group that the subsidy is intended to benefit. Such grants may be recoverable by the grantor if the terms of the subsidy agreement are not honored for a specified period of time, but they are not treated as loans during that time. Subsidies treated as deferred loans are like grants in that they do not need to be repaid as long as the terms of the subsidy agreement are honored. They may be secured with liens on the CLT's fee interest in the land, but they are usually forgiven – and the liens released – at the end of a specified regulatory period, so their effect is not much different from that of recoverable grants with similar regulatory periods. By structuring the subsidy as a deferred loan, the funder simply strengthens its ability to recover the subsidy if it is misused during the regulatory period. (Note, however, the possible concerns of leasehold mortgage lenders regarding liens on the CLT's fee interest in the land, as discussed below).

It should be emphasized that the long-term effect of permanent subsidies does not depend on the specific use for which the subsidy is formally designated or to which it is put. That is, it may be designated and used specifically for the acquisition of property, or specifically for the development or rehab of property, or it may be awarded and used at the time of the initial sale of homes to create affordability for income-qualified buyers (while remaining an asset of the CLT, not of the particular homebuyer). It is true that

CLTs would normally rather receive permanent subsidies as early in the development process as possible, since it is money on which the CLT will not need to pay interest during the process, but except for this effect the designated use does not make a long-term difference.

It is also useful to note the relationship – or lack of relationship – between permanent subsidies and land costs. As we have said, the amount of the subsidy is normally determined on the basis of what is needed to make a given home affordable for households at a given income level. This amount may be more or less than the cost of the land. Although it is sometimes said that what makes a CLT home affordable is the fact that the homeowner "doesn't have to pay for the land," it is much more accurate to say that what makes it affordable in the first place is simply the subsidy. What *keeps* it affordable, however, is another matter. In effect, the CLT, is able to preserve affordability by attaching the subsidy to the land that the CLT owns beneath the affordable home, regardless of whether the amount of the subsidy is more or less than the actual market value of the land.

Homebuyer-by-homebuyer subsidies. Most subsidized homeownership programs utilize homebuyer-by-homebuyer subsidies, which usually take the form of one or another type of deferred loan to the homebuyer secured with a second mortgage on the home. These subsidies are never as certain to preserve long-term affordability as what we have described above as "permanent subsidies," but CLTs are sometimes forced to make use of them for at least some of the subsidy needed in particular situations. It is important to recognize the differing long-term effects of the various types of homebuyer-by-homebuyer subsidies described below – and to do everything possible to avoid using homebuyer-by-homebuyer subsidies that cannot be passed on from one homebuyer to the next.

Subsidies as assumable deferred loans to the homeowner. If a CLT is forced to utilize a second mortgage deferred loan to a homebuyer as a source of at least some of the subsidy needed to make the home affordable for that homebuyer, then the CLT will definitely want that loan to be assumable by the next homebuyer. To the extent that such loans can never be forgiven or paid off and must be assumable, this approach allows subsidies to be recycled, though they are not locked into the CLT's own land holdings and their value will not appreciate as property values appreciate (but a CLT may still be able to preserve the affordability of the home, depending on the type of resale formula used).

Subsidies as fully recapturable deferred loans to the homeowner. The full amount of this type of subsidy must be repaid, possibly with interest, to the subsidy source when the home is sold (regardless of how long the home has been owned). These subsidies are not "privatized" by the homeowner, but the subsidy source has no obligation to make the subsidy available to the next buyer of the home. In effect, the CLT will need to start all over again to find enough subsidy – whether from the same source or a different one – to make the home affordable.

Subsidies as forgivable deferred loans to the homeowner. This type of second mortgage deferred loan can be "privatized" by the homeowner. If the home is resold within a specified period of time – ranging in length from 5 to 30 or more years – then the loan must be repaid to the subsidy source at the time of resale. But, if the home is not sold until this specified period of time has elapsed, then the loan is forgiven (never has to be repaid). In some cases, such loans are forgiven incrementally – e.g. 5% per year over a period of 20 years. Even if the loan is not forgiven – or is only partially forgiven – the subsidy source again has no obligation (and may have little or no capacity) to make a comparable subsidy available to the next buyer of that home.

Subsidies as deferred loans that build equity for the subsidy source. Sometimes called "shared equity loans," subsidies structured in this way will "grow" over time as the unrestricted market value of the home grows. When the home is resold the subsidy source will be repaid the original principal amount of the loan plus a percentage of any appreciation in the home's value equal to the percent of the original cost covered by the subsidy. For example, if a $50,000 subsidy is applied to a home valued at $200,000 – a subsidy thus covering 25% of the unrestricted value – and if the home is then valued at $300,000 when it is resold, the subsidy source would reclaim the original amount of $50,000 plus 25% of the $100,000 in appreciated value ($25,000), or a total of $75,000. This is a good way for a government entity to preserve the affordability-producing potential of its subsidies, but it is not a desirable way of subsidizing a particular CLT home if the government entity has no obligation (as normally it does not) to reinvest that affordability-producing potential in the same home.

Subsidies as partially deferred loans to the homeowner. Some subsidies are structured as second mortgage loans on which the homebuyer does not have to make amortization payments for a specified period of time, but with monthly amortization required after that period has elapsed. The assumption is that the homebuyer's income will increase over time so that she can begin to service the second mortgage loan as well as the first mortgage. Eventually the subsidy source may recover the full amount of the loan plus interest, but it has no obligation to make a comparable subsidy available to the next buyer of that CLT home. Not only will the CLT need to find more subsidy for the next homebuyer, but the first homebuyer who pays off the partially deferred loan will have paid something approaching an unsubsidized price for the home – which raises the question of whether it is appropriate for her resale price to be restricted. Such loans may be an appropriate way to make homeownership more feasible for certain (upwardly mobile) lower income people, but they are not an appropriate way of subsidizing CLT homeownership.

Mortgage interest subsidies. Mortgage interest subsidies reduce the homebuyer's costs by reducing the interest rate on the first mortgage loan rather than by covering a portion of the purchase price with a second mortgage loan. Like the approaches identified above these subsidies do not create permanently affordable homes but they can substantially reduce the monthly mortgage payments of a homeowner. In addition, since they allow a larger portion of the monthly payment to be credited to principal repayment, these subsidies can substantially increase the rate of equity buildup for the homeowner – unless the homeowner is required to repay the subsidy at the time of resale. If there is no subsidy-recapture provision, the homeowner whose mortgage interest is subsidized will receive a higher return on her investment than other homeowners who have paid the same price and are subject to the same resale formula. See Chapter 12, "Resale Formula Design," for a discussion of ways that CLTs may deal with this circumstance in designing resale price restrictions.

Dealing with Existing Policies and Programs

Clearly, it is important for CLTs to do everything possible to see that subsidies flow into their projects in forms that will allow them to be locked in permanently – or at least be passed on to the next homebuyer. Because the types of homebuyer-by-homebuyer subsidies described above are so common, new CLT programs – particularly in jurisdictions lacking previous experience with CLTs – may need to invest a good deal of time and energy in efforts to persuade government agencies to modify the guidelines of existing programs, or even to design new programs to capitalize on the CLT's ability to lock in subsidies.

Some states and municipalities have both programs that provide permanent subsidies directly to the nonprofit developers of affordable *rental* housing and other programs that subsidize *homeownership* on a homebuyer-by-homebuyer basis, but do not have programs that allow subsidies to be allocated directly to CLTs for permanently affordable CLT homeownership units. In such situations, a CLT may pursue any of three possible strategies, depending on the nature of specific regulations for existing programs, the relative difficulty of amending these regulations, and the willingness of public officials to either modify existing programs or create new ones. The CLT may (1) try for amendment of the guidelines for the rental subsidy program to allow these permanent subsidies to be used for the development of permanently affordable owner-occupied CLT homes, or (2) try for amendment of the regulations of the homeownership program to allow homebuyer-by-homebuyer subsidies to be converted to permanent subsidies directed to the CLT rather than to specific homebuyers, or (3) leave existing programs as they are and try for a new program specifically designed to provide permanent subsidies for CLT homeownership (or, more broadly, for any form of permanently affordable homeownership).

When it is workable at all, the third strategy is most likely to result in a subsidy program that will work smoothly for the CLT's purposes. Modifying existing programs can be a tortuous business. Even public officials who recognize the wisdom of permanent subsidies for permanently affordable owner-occupied homes, and who are therefore willing to amend regulations of existing programs to allow such subsidies, may still resist changes in any number of detailed regulatory provisions that don't really fit the CLT's program. For a CLT that has carefully designed its own ground lease provisions and related program guidelines, the ideal situation is to be able to take its plans to a government agency and ask for a commitment to fund what has already been designed, rather than spending time trying to bend the CLT program and an existing government program to somehow fit each other. Nonetheless, in the absence of governmental willingness to establish a subsidy program specifically for permanently affordable homeownership, many CLTs will need to invest effort in negotiating reasonable modifications of existing programs – most often modifications of existing homebuyer-by-homebuyer subsidy programs. Some of the more common issues that may need to be addressed in these negotiations are summarized below.

Common issues in adapting existing program regulations. CLTs seeking to utilize existing homeownership subsidy programs – whether trying to adapt homebuyer-by-homebuyer programs to accommodate the CLT program or trying to utilize newly authorized "shared-equity homeownership" programs – may need to work out one or more of the following issues with program administrators.

Administrator insistence on directing subsidy to homebuyer. Getting program administrators – who are used to thinking of homeownership subsidies as being, by definition, subsidies *to* homebuyers – to actually agree to disburse the subsidy to the CLT is *the* big hurdle. You may think you have prevailed on this point with the officials with whom you've been negotiating but then find yourself presented with proposed subsidy documents that still describe the homeowner as the recipient of the subsidy. The problem may be simply that the attorney who drafted the documents had not got the message – or it may be the broader problem of a lack of clarity among program staff about how the CLT deal ought to work. In these situations there is no substitute for patience and perseverance. Some of the other issues noted below may be addressed through compromise without seriously undermining the CLT's program, but on this issue, CLTs should be very slow to compromise.

CLT must be eligible transferee through purchase option. This is a technical point that is usually easily addressed with program attorneys or administrators, but it is important that the CLT makes sure that it *is* addressed. The regulations of existing subsidized homeownership programs typically permit the owner-occupant to sell the home only to other income-qualified households (unless the subsidy is to be recaptured by the source). The CLT should make sure that the subsidy documents also allow the home to be sold to the CLT itself, under the terms of the CLT's purchase option, for resale to other income-qualified households.

Homebuyer eligibility requirements. Normally a CLT must simply accept the subsidy program's guidelines regarding the maximum at-time-of-purchase incomes of households that will benefit from the subsidy. If the goal of the subsidy program is to serve households below 80% of Area Median Income but the CLT wants to sell a home to a family at 90% of AMI, then the CLT won't be able to use that program to subsidize that home. There are some other kinds of eligibility requirements, however, that may be more negotiable. Some homebuyer subsidies, for instance, are limited to first-time homebuyers. Program administrators are not likely to allow exceptions to such a rule, but there might be some room for compromise regarding the definition of "first-time homebuyer" (e.g., someone who has not owned a home in the past five years vs. someone who has *never* owned a home).

Criteria for possession of home by heirs. The Model CLT Lease (Section 10.3) allows the heirs of a deceased lessee-homeowner to assume the lease and occupy the home, even if they are not income-eligible, if they are members of that homeowner's family or if they have been living in the house for at least a year. Homebuyer subsidy programs often have more restrictive requirements on this matter. See the note on lease riders, below, if you plan to modify your lease on this point to conform to the requirements of a subsidy program.

Removal of income qualification for purchaser after 6 months. Article 10 of the Model CLT Lease allows a CLT home to be sold to someone who is not income-qualified if the home has been on the market for at least 6 months and still has not been sold. Homebuyer subsidy programs typically do not make this exception (meaning that the subsidy would be recaptured if the home were resold to a non-income-qualified buyer). On this point, too, see the note on lease riders if you plan to modify your lease on this point to conform to a program's requirements.

Lease fee levels. At least one administrator of a state homebuyer subsidy program has argued that the homeowner could not be required to pay a ground lease fee, "because the subsidy is paying for the land, so the homeowner shouldn't have to pay for it." A similar program in a different state (Michigan) *requires* the CLT to charge a lease fee of at least a specified monthly amount, so it will have the resources needed to monitor and oversee resales over the long-term.

Interest subsidy recapture issues. As noted above, mortgage interest subsidy programs may require the homeowner to repay some or all of the interest subsidy out of the proceeds from the eventual resale. In the case of at least one such program utilized by CLTs – USDA's "section 502 direct loan" program – the amount of subsidy to be recaptured, for most borrowers, depends on the amount by which the value of the property has increased during the seller's tenure, as measured by the difference between the original purchase price and the home's market value at the time of resale. However, the Housing and Community Development Act of 1992 modified this provision for CLTs so that the interest subsidy is to be recaptured out of the difference between the purchase price and the *restricted resale price* rather than the unrestricted market value at the time of resale. This fact may need to be pointed out to Rural Development administrators when a 502-financed CLT home is actually sold.

Liens on CLT's interest in the property. When a home is subsidized through a deferred loan to the homebuyer, a second mortgage lien is normally recorded against the homeowner's title to the home to secure the loan. If the home is subsidized, instead, through a deferred loan to the CLT, the subsidy source usually wants to record a lien against the CLT's interest in the land. If such a lien is recorded *before* a homebuyer's leasehold mortgage is recorded, it will raise a concern for the potential leasehold mortgagee unless the subsidy source will sign an agreement promising to respect the terms of the lease and the leasehold mortgagee's interest in the lease in the event that the subsidy source should ever foreclose its lien on the land. (See chapter 20, "Financing CLT Homes," regarding the new and more workable treatment of this issue in the 2011 version of the "Fannie Mae CLT Ground Lease Rider.") If the lien on the CLT's interest is not recorded prior to the sale of the home to the homebuyer, that lien can be subordinated to the leasehold mortgage lien so that there will be no problem for the leasehold mortgagee.

Use of Lease Riders to Modify Lease Terms to Satisfy Subsidy Sources. In situations where a CLT agrees to modify the terms of its lease in order to arrange for a subsidy in the form of a deferred loan to the CLT, the changes should never be made in the main body of the lease, which should retain the terms that the CLT wants to apply for the long term. The deferred loan in such cases will normally be forgiven – and the lien released – after a specified number of years. Any modifications of the lease terms required by the subsidy source should be stated in a rider to the lease that will apply only for the term of the deferred loan – and will then expire. The "Fannie Mae Rider" is an example of a similar lease rider reflecting the requirements of a leasehold mortgagee rather than of a subsidy source.

Effect of Subsidy Structure on Resale Formulas. Finally, it is also important to note that the way subsidies are structured can have a significant effect on the way that resale restrictions must be written. If the subsidy is to be held permanently by the CLT itself, then the amount of the subsidy is *excluded from* the "base price" that the homebuyer actually pays. If the subsidy takes the form of a deferred loan to the homebuyer, it is normally treated as *part* of the "settlement price" (as the price appears, for instance, in the "HUD 1 Settlement Statement"). In other words, the subsidy is treated in this latter case as part of what the homebuyer borrows to pay the settlement price. In such situations it is important to be sure that the formula is drafted in such a way that it is clear that the base price is *not* the settlement price. See Chapter 12, "Resale Formula Design," for further discussion of this issue.