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CHAPTER 3. GROUND LEASES

- \* 3-1. DEFINITIONS. When used in this Chapter, the words and phrases below are defined as follows:
- a. Fee Simple Estate. This represents the entire ownership, from beneath the soil to the air above, enduring by inheritance, indefinitely into the future. However, governmental limitations to the fee simple estate include taxation, condemnation, and police power (the power to regulate for the general good). Subject to these limitations, the owner of a fee simple estate may use the property and may exclude others from its use; he may dispose of the property by sale or by deeding it to another as a gift, or by allowing it to pass to an heir at his death including its bequest in the owner's will. The owner may also retain his ownership while allowing another person (a tenant) to use the property for a certain number of months or years in return for the payment of money (rent).
  - b. Lease. A lease is a contract between an owner (the lessor) and a tenant (the lessee) which contains a written agreement of the conditions under which the lessor transfers the use of real property to the lessee in return for lease payments (or rent.)
  - c. Ground Lease. The term ground lease is frequently used when a lessor leases an unimproved site to a lessee long enough (in years) to enable the lessee to construct a building on the leased site.
  - d. Ground Rent. The payments on a ground lease (as in paragraph 3-1c above) are frequently called ground rent, and must bear a reasonable relationship to the value of the site "as is" (before construction of on-site or off-site improvements).
  - e. Leasehold Estate. The interest of the lessee (user or tenant) under a ground lease for a term of years is called a leasehold estate. When the term of the lease expires, all rights to possession and use revert back to the lessor/fee simple owner and the leasehold estate terminates.
  - f. The Leased Fee. The interest of the lessor/fee simple owner during the period when the property is under lease. \*

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- \* g. In computing payments due under the lease, the terms "gross collections," "operating expenses and taxes," "net income before debt service payments," and "net cash flow" shall be defined as follows:
- (1) Gross collections (or effective gross income) shall mean the annual amount collected from all sources, less refunds.
  - (2) Operating expenses and taxes shall be composed of items of operating expense and taxes in accord with generally accepted accounting principles. However, for lease payment computations, taxes shall not include income taxes, and operating expenses shall not include interest charges, or charges or allowances for depreciation of real or personal property, or amortization of financing expense, or payments to any officer or director of the corporation, unless such payments are for services at the project which are necessary to the operation of the project. Conversely, operating expenses shall include the annual amounts deposited to replacement reserve funds.
  - (3) Net income before debt service payments shall mean the annual amount which remains after operating expenses and taxes (as defined in paragraph 3-1g(2) above) are subtracted from effective gross income (as defined in paragraph 3-1g(1) above).
  - (4) Debt service payments shall be the annual amounts paid to mortgage principal, interest, and mortgage insurance premium.
  - (5) Net cash flow shall be the annual amount remaining after debt service payments (as defined in paragraph 3-1g(4) above) are subtracted from net income (as defined in paragraph 3-1g(3) above).

3-2. TERM OF LEASE. In order to be acceptable for HUD mortgage insurance, the lease must be on the fee (not a sublease), and the remaining term of the lease (on the date of endorsement for insurance) must comply with one of the following: \*

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- \* a. Ninety-Nine Year Renewable Lease. A lease for not less than 99 years as originally executed, which is renewable with all

the same provisions contained in the original lease, may have any term remaining before the renewal date, provided the lessee has the right to renew with all the original provisions, including those concerning the ground rent.

- b. A Lease With Seventy-Five Years to Run. An existing or proposed lease may have a remaining term of not less than 75 years to run from the date the mortgage is executed.
  - c. For Certain Lessors, A Lease With Fifty Years to Run. An existing or proposed lease executed (or to be executed) by a governmental agency, an Indian, or Indian tribe, or such other lessor as the Commissioner may approve, may be for a term consistent with the maximum term for which the lessor has legal authority, provided that the remaining term of any such lease shall be not less than 50 years from the date the mortgage is executed.
  - d. Exceptions. Some special programs have minimum lease terms which are exceptions to the general rules stated in paragraph 3-2a, b, c above. A mobile home court ground lease may have a remaining term of not less than 50 years to run from the date the mortgage is executed. For nursing homes, the remaining term must be not less than 55 years. For a condominium, the remaining term may be 55 years if it contains an option to the lessee to extend the lease to a total term of 75 years from the date the mortgage is executed. Other exceptions may be found in the Regulations.
- 3-3. MARKETABILITY. For a home mortgage property, HUD requires a leasehold to be freely marketable in the local community, since most of the effective demand for purchasing a single family dwelling must come from residents of that community. On the other hand, the purchaser of a multifamily housing project (who frequently resides in another state) is typically an investor in a national or regional market of competing investments. The marketability of a rental project is based primarily on an investor's estimate of the present worth of the anticipated flow of future income. If the ground lease increases the cash flow to equity, most investors will consider marketability enhanced. However, the leasehold estate cannot be considered marketable unless the lease meets the underwriting review requirements described in paragraph 3-7. \*

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\* 3-4. REGULATION CHANGE FOR LEASEHOLD ESTATES.

- a. The Regulations formerly required, for leasehold estates, that the value or replacement cost of the property in fee

simple be reduced by an amount equal to the capitalized value of ground rent fixed in even payments of known amounts over the term of the lease.

- b. The Regulations were amended, on August 22, 1975, as follows:

"Reduced mortgage amount - leaseholds. In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value or replacement cost of the property described in the mortgage shall be the value or replacement cost of the leasehold estate (as determined by the Commissioner) which shall in all cases be less than the value or replacement cost of the property in fee simple."

- c. The purpose of the change is to permit the use of ground rentals at variable rates where leasehold estates are utilized in the various multifamily mortgage insurance programs. It is believed that sliding scale ground rentals are more realistic in terms of contemporary economics.

3-5. LEGAL REVIEW. The lease must receive both legal review and underwriting review. Neither of these reviews may be substituted for the other. For legal review, the file is referred to the HUD field office legal counsel having jurisdiction over the area in which the leasehold estate is located. Legal review shall establish that the proposed lease is in conformity with the applicable statute, HUD regulations, Form No. 2070 (the Lease Addendum model form), and applicable provisions of local law. Any substantive deviations from Form 2070 must be referred through the Regional Counsel to the Assistant General Counsel for Multifamily Mortgage Insurance.

3-6. UNDERWRITING REVIEW AT SAMA STAGE. Underwriting review of the lease is not performed at SAMA stage because review requires estimates of income, expense, debt service, and cash flow to equity which are made at conditional commitment stage, but which are not available at SAMA stage. At SAMA stage, valuation processing is confined to five actions listed in reference (7) of the Foreword. The value of the site fully improved (with off-sites installed) is the value in fee simple. The following paragraph must be added to the SAMA letter: \*

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\* "The Land Value Fully Improved (with offsite improvements installed) shown above is the estimated value in fee simple. The lease and the rental payments required by the lease have not been reviewed for acceptability for mortgage insurance. The lease will be reviewed at the conditional commitment stage because acceptability of the rental payments

under the lease can be determined only after conditional commitment processing has been performed."

3-7. UNDERWRITING REVIEW OF LEASE AT CONDITIONAL COMMITMENT STAGE.

In testing the lease payments for acceptability, the appraiser takes the following actions:

- a. The appraiser performs conditional commitment processing to develop the following estimates:
  - (1) Fair market value of land fully improved (in fee simple).
  - (2) Warranted price of site fully improved (in fee simple).
  - (3) Value of site "as is" (in fee simple).
  - (4) Gross income.
  - (5) Effective Gross Income.
  - (6) Total operating expenses and taxes.
  - (7) Net income.
  - (8) Replacement cost by formula (NOTE: The replacement cost formula to be used with leasehold estates is shown in Chapter 3, Figure 1.)
  - (9) Value of project (in fee simple) if applicable.
  - (10) Mortgage amount, by completing a valuation trial copy of Form 2264A. (NOTE: The value of the leased fee equals the value of site "as is" in fee simple, before construction of on-site or off-site improvements.)
  - (11) Annual debt service payments to principal, interest, and MIP.
  - (12) Annual cash flow to equity (after debt service payments but before ground lease payments.) \*

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\* (3-7) b. The appraiser analyzes lease provisions which determine the amount of annual lease rental payments (or ground rents). Although it has been administratively determined that certain kinds of ground rents will be permitted which vary with the passage of time, this must be accomplished without weakening the tests which are designed to assure that the

position of the mortgagor and of HUD in an insured mortgage secured by a leasehold estate would be no worse than if the property were held in fee.

- (1) Some methods of determining variable lease payments are not acceptable as these methods contain the danger of future payments being too burdensome to be made without default in mortgage payments. Examples of unacceptable methods of determining variable ground rents are:
  - (a) A graduated schedule of future increases on a lump sum year-by-year basis, or
  - (b) Increases by a cost-of-living index, or
  - (c) Increases based on the results of future appraisals.
  
- (2) However, the lease provisions may require ground rents computed by any or all of the following three acceptable methods of determining the ground rents, and rents so determined will be acceptable if the initial amounts are within underwriting limitations.
  - (a) A fixed percentage of gross collections (or effective gross income). The percentage must remain the same throughout the term of the lease.
  - (b) A fixed percentage of net cash flow to equity (after debt service payments but before lease payments). The percentage must remain the same throughout the term of the lease.
  - (c) A stated dollar amount per year which must remain fixed for at least 10 years more than the term of the insured mortgage. (If monthly or quarterly payments are required, these will be converted to annual amounts by the appraiser). When the \*

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\* (3-7) lease contains more than one method of computing lease payments, it will also indicate whether the amount to be paid shall be the greatest or the least, or the sum of these amounts. The stated annual dollar amount may be described as a minimum payment.

c. The appraiser estimates the lease payments, using the lump

sum annual amounts and percentages contained in the lease provisions, as applied to the estimated annual effective gross income or annual cash flow to equity indicated by conditional commitment processing on Form 2264. (The estimates are not based on the income which would be available during any period of deficit operation, but should reflect the effective gross income shown on Form 2264 and the corresponding cash flow to equity which result when sustaining occupancy has been reached.)

d. Example: Assume the facts are as shown in the following example:

LAND VALUE

Warranted Price of Land Fully Improved (In Fee Simple)	\$ 125,000
"As Is" Value of Land (In Fee Simple)	115,000
Value of Leased Fee	115,000

INCOME AND CASH FLOW

Estimated Effective Annual Gross Income, All Sources	\$ 242,455
Estimated Total Annual Expense (incl. Replace. Res.)	120,500
Estimated Net Income (before mortgage payments)	121,955
Annual Mortgage Payments (principal, interest, MIP)	99,661
Estimated Annual Cash Flow to Equity (before ground rent)	22,294 *

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\* (3-7) ESTIMATED REPLACEMENT COST AND MORTGAGE AMOUNT

Estimated Replacement Cost (or Value) of Project (In Fee Simple)	\$ 1,250,000
Estimated Value of the Leased Fee	115,000
Estimated Replacement Cost (or Value) of Project (leasehold Estate)	1,135,000
Maximum Mortgage Amount From Form 2264A (Leasehold Estate)	1,021,500

ANNUAL GROUND RENT REQUIRED

Assume that provisions of the lease require annual lease payments to equal the greatest of the three following amounts:

- 1 Three percent (3%) of annual gross collections;
- 2 Twenty percent (20%) of annual net cash flow to equity (after debt service payments but before lease payments); and
- 3 Seven Thousand Dollars (\$7,000.00) per year minimum.

Using estimates previously made in his appraisal for annual gross collections (effective gross income), and for the annual net cash flow to equity (after debt service payments but before lease payments), the appraiser estimates the three amounts as follows:

- 1 3% of annual gross collections  
(\$242,455) = \$7,274
- 2 20% of annual net cash flow (\$22,294) = \$4,459
- 3 \$7,000 per year, minimum = \$7,000

The appraiser notes that the amount of initial ground rent required by the lease is the greatest of these three amounts: 3% of annual gross collections, or \$7,274. This amount is next tested to determine whether it is within permissible limits.

- e. Test for Acceptability of Variable Lease Payments. In the above example (paragraph d), the appraiser has determined the initial annual ground rent required by the lease to be \*

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\* (3-7) \$7,274, based on the estimate of annual gross collections (effective gross income) used in the appraisal. To be acceptable, the annual ground rents must not exceed the value of the site "as is" in fee simple (\$115,000) multiplied by 90% of the interest rate of the insured mortgage (.90 x .09 = .081). Thus \$115,000 x .081 = \$9,315. The ground rent (\$7,274) is less than (\$9,315) the value of the site "as is" multiplied by 90% of the interest rate of the insured mortgage; therefore, the annual rent is acceptable. The ground rent determined by any of the three acceptable methods for determining ground rent must meet the test described in this paragraph except for those projects with level lease payments only, described in subparagraph g.

- f. Form No. 2070, 207 Lease Addendum. The appraiser also reviews provisions of the lease (other than those concerned with annual lease payments) to determine that they will not

restrict the successful operation of the project. In analyzing the lease, the appraiser must keep in mind that the provisions of Form 2070, the 207 Lease Addendum, must be included in, or legally appended to, the lease. The proposed lease must not contain any provisions in conflict with the lease addendum. If the above conditions are met and the annual lease payments required under the lease meet the test for acceptability described above, the appraiser recommends that the lease be accepted.

- g. Test for Acceptability of Level Lease Payments. The provisions of the lease may require only payments which are a stated dollar amount per year, and these stated annual ground rent payments must remain fixed for at least 10 years more than the term of the insured mortgage. In other words, the lease may require payments which are in accord with paragraph 3-7b(2)(c), a stated dollar amount, but may not require payments in accord with paragraph 3-7b(2)(a), a fixed percentage of gross collections, or paragraph 3-7b(2)(c) a fixed percentage of net cash flow to equity (after mortgage payments but before ground lease payments). In such case, the amount of stated annual ground rent will be acceptable if it does not exceed the value of the site "as is" multiplied by 100% of the interest rate of the insured mortgage. \*

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- \* (1) A Section 236 project on a leasehold estate may not have lease payments which are percentages of gross collections or cash flow, but must have lease payments in level stated dollar amounts which must not exceed the "as is" value of the project site multiplied by 6%.
- (2) A condominium unit which is a leasehold estate may not have lease payments which are percentages of gross collections or cash flow, but must have lease payments in level stated dollar amounts which must meet the following test: the unit annual lease payments may not exceed the "as is" value of the project site multiplied by the unit value ratio multiplied by 100% of the interest rate of the insured mortgage.
- 3-8. GROUND RENT DURING CONSTRUCTION. For proposed construction under all sections of the Act, lease payments during construction may be included in the estimated replacement cost of the project (and also in the certified cost), subject to the following conditions:
- a. The period for which ground rent is estimated is the same as

that for which interest and other related charges are calculated, namely, the estimated construction time plus two months.

- b. Ground rent during construction is interlined in Form 2264 just above the line for warranted price of land.
  - c. Ground rent is not to be included in the base on which Builder and Sponsor Profit and Risk Allowance (BSPRA) is calculated.
  - d. The annual amount of ground rent during construction may not exceed the test for acceptability of lease payments described in paragraph 3-7e. If there is no escalation of lease payments until after the term of the mortgage, the test for acceptability of lease payments (described in paragraph 3-7g) may be used.
- 3-9. REPLACEMENT COST BY FORMULA. A formula which will provide the total project replacement cost and mortgage amount, based on cost for proposed construction where a leasehold estate is \*

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\* involved, is shown in Chapter 3, Figure 1. This formula provides both for Sections of the Act which use BSPRA and also those without BSPRA. A separate formula is necessary for leasehold properties because the mortgage amount is less than it would be if no ground lease were involved.

- 3-10. VALUE OF THE LEASED FEE. The procedures for estimating the value of the leased fee are composed of a general rule and two exceptions.
- a. General Rule. Except as provided in subparagraphs b and c below, the value of the leased fee must be estimated to equal the market value of the site "as is" in fee simple. The value of the leased fee must equal the value of the site "as is" regardless of whether the ground rent is an escalating amount based on a percentage of gross collections, or cash flow, or whether it is a level stated dollar amount each year.
    - (1) The value of the leased fee, so estimated, is entered in the appropriate space in line K-6, Form 2264.
    - (2) Next, the annual ground rent (estimated as shown in paragraph 3-7c and d, based on the lease provisions and estimates of income and expense used in the appraisal) is entered in the appropriate space in line K-6, Form

2264.

(3) Dividing the ground rent by the value of the leased fee will result in the earning rate indicated by this ground rent. This rate is also entered in line K-6.

b. Exception For Leases Containing An Option to Buy. In cases which meet the following conditions, the value of the leased fee may be estimated by capitalizing the ground rent.

(1) The lease must give the lessee an option to buy the site in fee simple for a stated purchase price at some time during the term of the lease. This stated purchase price must not exceed the value of the leased fee estimated by capitalization at the time of project processing. \*

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\* (2) The annual ground rent required by the lease must be level payments of a stated dollar amount. The amount of these payments must remain unchanged from the date of mortgage endorsement to at least ten years after the mortgage term.

(3) The capitalization rate used must be the market capitalization rate for similar investments except that it may never exceed the interest rate of the insured mortgage. The ground rent divided by the capitalization rate results in the estimated value of the leased fee to be entered in line K-6, Form 2264.

c. Exception For Section 236. A Section 236 project on a leasehold estate may not have ground lease payments which are a percentage of annual gross collections or cash flow but must have lease payments in level stated dollar amounts which must not exceed the "as is" value of the project site in fee simple multiplied by 6%. To estimate the value of the leased fee, the appraiser divides the annual ground rent by the market capitalization rate for similar investments. This ground rent capitalization rate may not exceed 6%.

3-11. OPTION PRICE FOR ASSISTANT SECRETARY FOR HOUSING - FEDERAL HOUSING COMMISSIONER. The Assistant Secretary - Federal Housing Commissioner's option price in the lease addendum must reflect the value of the leased fee in Form 2264.

3-12. GROUND LEASED FROM PUBLIC BODIES. Where sites are leased by a public body to a developer for a specific purpose, the procedures outlined in this Chapter remain unchanged, except

that the "as is" market value of the site in fee simple (before construction of on-site and off-site improvements) may not exceed the value of the leased fee.

- 3-13. COMMENTS FROM HOUSING MANAGEMENT. When Form 2264 has been completed, a copy of this form and related forms is transmitted to Housing Management for comment concerning the lease. HM comment is returned to the Chief Underwriter who shall route all HM recommendations which concern valuation processing to the processing appraiser. The processing appraiser must objectively consider HM recommendations within the context of his responsibility to process leasehold estates in conformity with this Chapter. \*

- 3-14. TANDEM PLAN FINANCING. When tandem plan financing is used, the interest rate of the insured mortgage is somewhat reduced from the maximum market interest rate which HUD would permit through the mechanism of a GNMA subsidy. The effect of mortgaging a leasehold estate rather than a fee simple estate in such a transaction is that the mortgage on the leasehold estate (and therefore the tandem plan subsidy) are smaller than they would be if the same property were mortgaged in fee simple. Yet, this would not necessarily lower the market rate of return for the leased fee, and it might be impossible to obtain a long-term ground lease at the rate of return which does not exceed the tandem plan mortgage interest rate.
- a. For the above reasons, whenever tandem plan financing is used, the multifamily HUD maximum permissible interest rate shall be substituted for the interest rate of the insured mortgage in testing for the acceptability of lease payments in accord with paragraphs 3-7e and 3-7g (except that this does not apply to Section 236 projects).
  - b. Also, in tandem plan financed projects (except those insured under Section 236), the multifamily HUD maximum permissible interest rate shall be substituted for the tandem plan interest rate of the insured mortgage in appraising the leased fee by capitalization as required by paragraph 3-10b of this chapter.
- \* 3-15. DIRECT LOAN FINANCING. Financing by direct loan under Section 202 also permits mortgage interest rates less than market rates. However, this would not necessarily lower the market rate of return for the leased fee, and it might be impossible to obtain a long-term ground lease at a rate of return which does not exceed the direct loan interest rate.



