

Lease Options

1 — LEASE-OPTION ADVANTAGES AND DISADVANTAGES FOR SELLERS. Many property sellers think lease-options are bad for sellers but good for buyers. As a lease-option seller of many rental houses, I strongly disagree. Lease-options have been very good for me. Rarely did I have any competition from other lease-option sellers. The result was I had my pick of the buyers. *Although we'll discuss houses in this column, please remember lease-options can be used on any type of property.* Here are the primary pros and cons for lease-option sellers:

A — Advantage: There are always more lease-option buyers than sellers. Whether you own a run-down slum property, or a multi-million-dollar estate house, when properly marketed, there is always strong demand from lease-option buyers.

B — Advantage: Lease-option tenants are above-average-quality tenants. Just as landlords must learn to properly screen their tenants, such as by running credit reports and checking references of their previous landlords, lease-option sellers should use the same criteria. My experience has been lease-option tenants are quality people who eventually expect to own the property so they will treat it well. I only had one bad experience and that was my fault.

EXAMPLE: I lease-optioned a house to an unmarried couple, Chris and Andriana, based on the recommendation of a good friend. I didn't check their credit or their rental history with their previous landlords, as I should have done. This couple split up when their 12-month lease-option expired. Meanwhile, without my permission they brought a ferret into the house! That little critter did extensive damage to the woodwork and carpet. But they were paying higher-than-market rent — as lease-option tenants expect to do — and they walked away from their \$6,000 rent credit, which was more than enough to repair the damage. I was actually grateful because when they moved out, the market was "hot" and I sold that house for considerably more than their option purchase price.

C — Advantage: Lease-option tenants expect to pay higher-than-market rent (in return for a rent credit toward the option purchase price). To my pleasant surprise, a few years ago I learned lease-option tenants don't mind paying higher-than-market rent. One of my lease-option tenants, Ginin, educated me on how she and her husband, Jose, viewed their lease-option. "We pay you \$1,500 per month rent with a \$500 per month rent credit. We view that as \$1,000 low rent for a nice house and \$500 into a forced savings account toward our down payment."

Although I didn't tell Ginin, I viewed it as \$1,500 above-market rent to pay my mortgage payment and other expenses for that house. By the way, lease-option sellers should be sure to report all the monthly rent received as rental income on Schedule E of their income tax returns. If the option is not exercised, then the IRS cannot say the landlord failed to report all the rental income. Schedule E is, of course, where the tenant deducts the applicable expenses, including depreciation, which should mostly offset the rental income. However, when the tenant exercises the lease-option (as Ginin and Jose did), the rent credit is subtracted from the gross sales price as a selling expense, just as a Realtor's sales commission is subtracted from the gross sales price to arrive at the net or "adjusted sales price."

D — Advantage: Landlord receives non-refundable option consideration and/or prepaid rent. When selling on a lease-option, for the seller's protection the buyer should pay a substantial non-refundable option consideration and/or prepaid rent. The amount paid up-front will depend on the market value of the property and the seller's cash needs. Until the option is exercised, option consideration need not be reported to the IRS — the reason is the seller doesn't know if this

money will become part of the buyer's down payment, which is partially non-taxable return of investment and partially capital gain. If the option is not exercised, such as in my earlier example of Chris and Andriana, then the forfeited option money becomes ordinary taxable income to the landlord.

E — Advantage: Lease-option buyers will pay top dollar for the option price. As a seller of houses on lease-options, I can't recall a buyer ever questioning my option purchase price. I always set the price at the top of the range of market values for the property. Because they are so thrilled to find a lease-option, lease-option buyers won't argue over the price unless it is unreasonable. Most buyers are smart. They recognize a "good deal" when they see it. As the old saying goes, "Don't steal in slow motion." However, lease-option sellers shouldn't get greedy.

F — Advantage: Seller keeps the income tax deductions, including depreciation, during the lease-option term. It is very important for lease-option sellers to understand they, not the lease-option buyers, get the beneficial income-tax deductions during the lease-option term. This fact can be extremely important for sellers who can continue using their depreciation deduction to offset the potentially taxable lease-option rental income. However, when the option is exercised, all or part of the depreciation may be "recaptured" and taxed at the time of sale. Of course, a great way to avoid such recapture taxation is for the lease-option seller to make a tax-deferred exchange.

G — Disadvantage: Lack of an immediate cash sale. If you need an immediate cash sale of your home or investment property, a lease-option might not be right for you. However, if you are in no hurry to close the sale, but need rental income to pay the property expenses, a lease option can enable you to (1) receive top option sales price for your property, (2) earn top rent, and (3) have super-quality tenants who have a vested interest occupying your property. A lease-option for a year or two is then ideal for you.

As a lease-option seller, I recommend one-year lease-options. This gives me the opportunity to "adjust" the rent and/or option purchase price when the 12-month purchase option expires. If the tenant has proven troublesome (that never happened to me), I wouldn't renew the lease-option. I've renewed lease-options for as many as five years. After that, I told my tenants, "Either buy your home or move out." They all exercised their options and bought!