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Lease-Option or Installment Sale?

By Spencer Roane

Some states do not consider Lease-Option (L-O) transactions to be mortgages; therefore, not subject to S.A.F.E. Act licensure. Since terms like L-O were loosely defined before the S.A.F.E. Act, there is still a good bit of confusion about the L-O transaction and how it should be structured. Confusion also exists regarding other similar transactions – lease purchase (L-P) and rent-to-own (RTO). While L-O is understood to be a “lease with an option to purchase”, L-P is a ‘lease with an obligation to purchase’, and RTO involves ‘equal payments until ownership is transferred’. The two latter transactions are generally considered credit transactions (ie – installment sales), or “mortgages” when applied to a house or dwelling and, as such, require S.A.F.E. Act licenses.

Here’s an interesting article, by a very reputable source, that discusses characteristics of a L-O transaction that differentiate it from an installment sale.

<http://www.ccim.com/cire-magazine/articles/lease-option-or-installment-sale>

The following highlights of this article are viewed from the perspective of manufactured homes (MHs) in land lease lifestyle communities.¹

A L-O transaction is less likely to be considered an installment sale when it has the following characteristics:

- The lessor essentially owns the asset until lessee exercises the option.
- The Option Payment (amount paid up-front for the option, or right to purchase) must be a significant portion of the value of the asset (so don’t make the Option Payment \$1 or a “security deposit”).
- Lease payments don’t substantially exceed the fair market rental of the asset.
- No portion of the lease payments apply toward purchase of the asset.
- The Option Price (amount paid to purchase the asset once the option is exercised) is about equal to the fair market value of the asset at that point in time – not a nominal amount or simply the last lease payment.
- There is no certainty or requirement that the lessee exercise the option to protect an “investment” in the asset.
- No “side deals” or hidden agendas/incentives exist between lessor and lessee.

Furthermore, the option price must not appear to be an installment sale balloon payment. The depreciating nature of manufactured homes generally supports a lower option price, than one would expect, if the transaction involved real estate. Accordingly, one might support the option price in a manufactured home L-O transaction with MH sales data, ‘book value’ (eg – NADA), and agreement between lessor and lessee at inception of the L-O agreement, that the option

price approximates expected fair market value of the MH at the time the option might be exercised.

Finally, the lessor might choose to finance the option price, once lessee exercises the option. Since a “mortgage” is frequently defined as an installment sale where lender holds a security interest in the asset (or “dwelling”, as defined in the S.A.F.E. Act), one might avoid creation of a ‘mortgage’ by surrendering the MH title to the buyer/borrower, replacing the security interest with an unsecured promissory note from the lessee/borrower. And lessor might justify relinquishing the MH title, considering lessee’s payment history and possible cost of relocating the MH.

Additional MH L-O info is available in the references at the bottom of this page
<http://leaseoptionmhsales.com/information/>

End note

1. Land lease lifestyle community (a.k.a. manufactured home community)