

Lease Option Sales Transactions Gaining in Popularity!

by Spencer Roane

Originally published April, 2011
Revised and reprinted August, 2012

Overview

During the past two years many state associations and Manufactured Housing Institute ('MHI') have done a good job apprising us of the dangers of the S.A.F.E. Act, federal legislation designed to prevent mortgage fraud, like that which caused the US housing industry meltdown. By requiring registration and licensing of those who originate or broker mortgage loans, and regulating their activities, federal and state authorities have done their best to ensure 'no-doc loans', inflated appraisals, fabricated credit, graduated payments, adjustable interest rate surprises, and under-the-table loan officer compensation, all slip into oblivion. None of these new regulations were intended to affect the business of reasonable and ethical landlease community operators (COs) who seller-finance the sale of manufactured homes (MHs). Unfortunately, they do impact those who use various forms of credit transactions. Fortunately, there is an alternative which COs in many states are now using: Lease-Option (L-O) contracts.

Definitions and Clarifications

A Retail Installment Contract (RIC) is what most of us think of as "seller financing". A typical RIC involves a principal amount financed, downpayment, annual interest rate, term, amortization schedule, and security interest in the asset being financed. Clearly, a RIC is a credit transaction. Although numerous attempts have been made to exclude manufactured housing RIC transactions from the S.A.F.E. Act, based on personal property, seller-financing, de minimis sales volume, etc., little relief has been granted by regulatory authorities.

L-O "financing" involves a lease with an option to purchase the asset during or after the lease term, not to be confused other forms of credit transactions like Rent-to-Own or Lease-Purchase, which involves a lease with an obligation to purchase.

Characteristics of a Lease-Option Contract

An L-O contract should include the following:

- Option payment – amount paid up-front for the option to purchase the MH
- Lease – rights and obligations of lessor and lessee, including possession, monthly payment, term, and other issues such as maintenance, insurance, and property tax

- Purchase Option – amounts lessee can purchase MH for, at various points during the lease. Each purchase amount should be approximately equal to the fair market value of the MH at that time.
- Procedural note - if lessor finances the purchase (when the option is exercised), lessor should surrender the title to lessee (so lessor holds no security interest). See example below.

What Should a Lease-Option Contract Not Contain?

L-O monthly payments should be separate from site rent, preferably in amount and timing. For example, site rent of \$250 might be due on the first of the month and the L-O payment of \$300 might be due on the tenth of the month. Credit terms such as interest rate, amortization schedule, portion of monthly payment applied to purchase, or balloon payment have no place in an L-O contract.

Give Me an Example of a Lease-Option Transaction

Lessee agrees to pay \$300 per month to lease the MH for 8 years. Lessee is responsible for maintenance, taxes, and insurance. Lessee also pays \$1,500 at the beginning of the lease for the option to purchase the MH during or immediately after the lease term. Purchase price alternatives are \$19,000, \$14,000, and \$4,500 at the end of 2, 5, or 8 years, respectively. If Lessee exercises the option, the cost of the option (\$1,500) will be deducted from the purchase price. If Lessee exercises the option at the end of the 8 year lease, lessor may, but is not obligated to, accept the remaining purchase price in twelve payments of \$250 each. If lessor agrees to accept those purchase payments over that twelve-month period, lessor also surrenders the MH title to lessee in exchange for an unsecured promissory note.

Why a Lease-Option Contract May Not Be Subject to the S.A.F.E. Act

The S.A.F.E. Act applies to mortgages - and in most states mortgages involve a credit transaction with a security interest in the underlying asset. There is no security interest in a lease. If lessor surrenders the title to lessee when lessor finances the purchase price of the MH, then no security interest exists during the financing, and thus, no mortgage is created!

Why Would Lessor Consider Surrendering

the Title to the MH? ▲

At the time the option would be exercised, lessor would have extensive experience with lessee's payment history. The amount owed to purchase the MH is relatively insignificant, compared to payments lessee will already have made. Lessor would likely consider lessee highly motivated to conclude his purchase obligation. The cost of moving the MH to another location would be more than the amount owed to purchase the MH. Lessor would still be protected with an unsecured promissory note.

Other Related Issues ▲

What about sales and use tax?

Sales and use tax is a state issue. It is charged in some states on the sales price of the MH (when the lessee exercises the option), and is generally not charged on lease income.

Are S.A.F.E. Act licenses required to retrieve an applicant's credit report?

No, but other regulations apply to credit reporting (see below)

What are lessee pros & cons?

This is a viable means of achieving home ownership. No tax-deductible interest payments. Home buyer credits and incentives may not apply. Lease and associated benefits, possibly including equity, could be transferred with lessor's permission.

What are the lessor accounting entries for L-O transactions?

Pre-paid option is recognized on default or when option is exercised. Home is depreciated. Lease payments are similar to rental income. Loss on sale of home is recognized when option is exercised (see below).

What are lessor pros & cons?

Fills vacant sites. Newer homes upgrade communities. Capital to acquire homes. Resident pride of ownership. Reduce common-area expenses. Higher downpayment than rental security deposit. Repossession rates and costs commensurate with in-community rental or RIC alternatives.

Where Can I Get Sample Paperwork? ▲

Free copies of sample paperwork, including a L-O contract, a step-by-step guide to L-O transactions, and L-O accounting entries are posted on the author's website www.LeaseOptionMHSales.com.

How Prevalent Are Lease-Option Transactions? ▲

Many smaller community owners have used varying versions of L-O contracts to sell homes over the past 20+ years. An interesting development that emerged from MHI's NCC meeting in Washington, DC (March, 2011) was that larger portfolio owners operating in more than 30 states are employing L-O contracts over conventional credit transactions.

A Few Words of Caution ▲

The S.A.F.E. Act is federal banking legislation interpreted differently by different states. The arguments and procedures outlined above may not be acceptable in all states. Also, from time to time HUD and the newly-created CFPB issue "guidance" on various facets of the legislation which might affect these arguments. Even in states which do not require S.A.F.E. Act licenses for L-O sales, some states may require other licenses such as a consumer lending license. Check with an attorney familiar with the laws in the state(s) in which you operate.

Even if S.A.F.E. Act licenses are not required for L-O transactions, other Federal regulations may apply. To list a few: Fair Credit Reporting Act (FCRA), Fair and Accurate Credit Transactions (FACT) and Red Flag Rules addressing identity theft, the Gramm-Leach-Bliley Act (GLB) addressing protection and privacy of consumer personal financial information, Civil Rights Act, Equal Credit Opportunity Act (ECOA), Community Reinvestment Act (CRA), Homeowners Equity Protection Act (HOEPA) prohibiting predatory lending, and Regulation M addressing disclosures required in consumer leases.

Disclaimer ▲

The information contained herein reflects the opinion and experience of the author and not necessarily held or known by this publication or MHI. Always seek legal and accounting counsel in matters like this.

Thank You! ▲

The author sincerely appreciates the assistance of many community owners, large and small, who shared helpful information; Mr. Lex Watson Esquire of Merritt-Watson in Atlanta for his research of L-O transactions; Mr. Ken Rishel of Rishel Consulting for helping ensure reservations with L-O financing were addressed; MHI and our state trade associations for providing forums for the exchange of ideas; and George Allen of GFA Management, Inc. for providing the forum for the exchange of ideas (Networking Roundtable), and for disseminating this, and other similarly useful information, to landlease community owners around the country.

Spencer Roane, Atlanta, GA, owns and manages four land lease communities in Georgia and Texas. His firm has sold manufactured homes on lease-option contracts in his communities over the past 20 years, involving more than 600 transactions. He has served as an officer and board member of the Georgia Manufactured Housing Association and currently serves on MHI's National Communities Council and Disaster Housing Task Force. His formal education consists of a BS in Electrical Engineering and a MS in Industrial Management. He holds other certificates and licenses, including insurance, wastewater, mortgage loan originator, and mortgage broker. Contact him at spencer@roane.com or (678) 428-0212.