

# Lease Options vs. Subject Tos

## When to consider these techniques

By Wendy Patton

© 2008 by Wendy Patton

## CCIA Speaker: April 20, 2008

Lease Options and Subject Tos, aka “Getting the Deed” are two very popular ways to purchase real estate with little or no money down. Acquiring investment real estate can be handled with many different approaches, but these two techniques can be implemented with little or no money down in most incidences.

A lease option is a technique which involves gaining ‘control’ of a property, but not owning it. It is the right to possess a property now and purchase that property at some future date with terms you define when you buy it.

A “Subject To” is getting the deed to a property without getting a mortgage for the home. Instead, the seller signs over the deed to his home ‘subject to’ the existing mortgage. The buyer in this case makes the mortgage payments on the old loan, but does not need to get a mortgage themselves to acquire this home.

Both of these techniques usually require little or no money down. In both of these techniques it is possible for the buyer to get money from the seller or the purchaser (or both!) in the beginning of the transaction. These techniques, when used properly, will provide for huge profits. They are both awesome, and when used hand-in-hand by investors are almost an unbeatable pair!

This short article is not meant to give details of each technique, but rather to show when you could consider either of them. If you don’t understand how to document and protect yourself in each kind of technique, then purchase a home study course or my book called ‘Investing in Real Estate with Lease Options and Subject Tos’. It can be found on my website – [www.WendyPatton.com](http://www.WendyPatton.com).

### Why Knowing Both Techniques Means More Great Deals For You!

Unfortunately there are many people that are teaching that you should only do the Subject To – technique. They recommend never buying on an option. I can’t tell you how many times I have heard, “If I don’t get the deed, I don’t do the deal”. With over 20 year’s of experience (since 1985) doing both types of deals, I have to disagree with that statement. The more tools and techniques and ways you have to purchase property or to structure a deal, the more likely you will be able to work

with a motivated seller to come to a potential solution. If you only buy “Subject To”, you’ll walk away from a LOT of great deals in your real estate career, but you must know when each technique is appropriate to use.

Finding a motivated seller is the first step to any good real estate deal. There are many types of motivated sellers, but we tend to think of motivated sellers as the ones that are financially distressed. I like to look at motivation from a much wider range. Let me explain. I like to divide motivated sellers into two groups:

<b><u>Situation</u></b> Sellers that have Bad Debt	VS.	<b><u>Situation</u></b> Sellers that have Good Debt
<b><u>Solution</u></b> Get the Deed – NO Lease Option!		<b><u>Solution</u></b> Lease Option or Get the Deed!

Sellers that have “Bad Debt” are those in financial trouble. They might be behind on a mortgage, have lost their job, acquired an illness, going through a divorce, etc. In these situations, you need to get the deed either with a Subject To or an outright purchase. Your main concern is that this type of seller will continue to have financial problems that could affect the title to “your” property if the deed is still in their name. For example, if this seller gets judgments from creditors, they can attach to any real estate the seller owns - they will have to be paid off before you can exercise your option to buy. That’s why you want to get this type of seller off of the title.

Sellers that have “Good Debt” are those NOT “in trouble” in the traditional sense, but they do have a reason motivating them to sell. Their problem is not one of financial desperation—it is usually just a change in their life. They might be transferring to a new location for a promotion, getting married (each owning their own home), building a new home, burned out landlords, etc.

### **Example #1: Here is an example when you MUST get the deed:**

A seller calls you on the phone and says he is 2 months behind on payments. Do NOT option this home! This seller is in trouble financially and is not a good risk for an option. Anyone that is in a bad financial situation is not a good seller for an option. This is the type of seller that you must get off of the deed so that his financial situation will not affect the title to the property in the future.

Not every seller who is in financial trouble will tell you so, which is why you ALWAYS need to do research on the title before you get the deed or do an option. In this case, you will need to bring

the seller's mortgage current. Before you do, you want to make sure that he is owner of the property and there are no other liens on the property.

### **Example #2: Here is an example when you COULD get the deed:**

A seller calls you who owes \$135,000 on his home—which is worth \$145,000. Since there is not much equity in this property, this type of seller might very well be willing to give you the deed. If there is high appreciation in the area, or a very low payment, you might be able to make a profit even though there's no equity. However, be careful that you have evaluated the numbers correctly before you take the deed.

On the other hand, if the seller's payment is too high or the market is slow, you might need to have the seller pay you to take the deed. Yes, there are sellers who will pay you to take the deed to their home. Think about it: if this seller sells conventionally—that is, through a Realtor, he would have to pay up to \$10,000 in commission to sell his home. Plus, he'll have closing costs, transfer taxes, and will probably pay points or fees on behalf of his buyer. If he's willing to pay all this money to an agent to sell the property and wait 90-120 days to sell, why shouldn't he just pay you to take over his payments NOW?

If the seller didn't have the cash to give you, an option would be your best strategy. This way, the seller can pay you the \$10,000 over time, or you could arrange for the seller to pay part of the monthly payment during the option period. This way, if he stops paying his portion of the payments, you have the choice of surrendering your option and simply giving the property back to him. When you have the deed, you normally can't do this.

### **Example #3: Here is an example where you SHOULD lease option or lease purchase:**

A doctor has a new home built for himself. His old home is worth \$200,000 and he owes \$125,000. He has \$75,000 of equity. He is not behind on payments, and he did not need the \$75,000 of his equity to buy the new home. His old home is sitting vacant and the realtor has not sold it yet. He qualified for both house payments at the bank and he can technically afford both, but who wants to make an extra house payment?

Although he is motivated to sell because he's coming out of pocket every month to own a vacant property, this type of seller is NOT going to simply give you the deed and let you take over the mortgage. There is no way he is going to give up all of his \$75,000 in equity, and no way are you going to pay that much cash out of pocket.

When you lease option this house, he gets most of his equity back—although it won't happen until YOU sell the property. The deal might work like this: you option the property for \$185,000, and make payments to the seller that equal his total mortgage payments. You SELL the property on an 18

month lease option for \$218,000 with payments to match. You get cash flow + \$33,000 in profit when your tenant/buyer buys the property; the seller gets his payments taken care of for a few years, then gets the bulk of his equity out. And in the meantime, he doesn't have to worry about management, vandals, frozen pipes, and all of the other things that owners of vacant houses have to deal with.

### **Example #4: Here is an example where you COULD lease option or lease purchase:**

A seller just inherited a property worth \$120,000 from their parent's estate. It is owned free and clear and they don't want to be paid off. They don't need the cash, but they would love some cash flow on this asset. This seller is not going to give you the deed. Let's say you can lease option this property for \$700 per month with \$300 per month going to the purchase – or the option credit. Your real payment in this case is only \$400. You can compare these numbers with doing a seller financed type of arrangement. See what works the best and make that offer first.

### **Let's examine a seller financing deal:**

A seller financed deal means that the seller will finance a mortgage for the buyer and the buyer pays their mortgage payment/interest to the seller versus a bank. This is primarily done when the seller owns a home free and clear and they do not have a mortgage on it themselves. It can be called a land contract, contract for deed, or private money mortgage. It will depend on how the offer is made and accepted. Let's say you negotiate a deal with the seller for a sales price of \$110,000 – if you want your payment to be \$700.00 as in the above lease option example, let's see what that really means to a seller for a seller financed deal. First in a seller financing or mortgage your payment includes taxes and insurance (unless the buyer pays them themselves). This must be subtracted from the \$700. Each part of the country fluctuates, so I will use an estimate of \$250 per month for taxes and insurance. This leaves \$450 for the seller. Now we must subtract our principal we negotiated above the \$300 per month credit. This now leaves the seller with \$150 per month. If this were to be all that is left this would essentially mean the seller is receiving 1.6-1.7% interest on their money. The interest rate has to be disclosed on the loan document or seller financed deal. A very low interest rate is much harder for a seller to accept than a lease option payment of \$700 per month. It is the same thing to the seller, but it is spelled out differently. They don't do the subtraction themselves to calculate the real rate of return. If you do a seller financing deal, you must calculate and show it in writing. Compare the two and see what works the best.

Let's examine the pros and cons of Subject To vs. Lease Options:

<b><u>Subject To Pros:</u></b>	<b><u>Subject To Cons:</u></b>
Title is in your name – full ownership	You own it and have ethical responsibility

## Featured Speaker Article

	to the seller even if the market changes or you can't sell the home. You own it! No changing your mind on this one.
Some sellers will pay you to take the deed.	You will need to get new insurance policy naming you or your company on the policy. In some instances this might trigger the 'due on sale' clause. You must insure it based on the title (who is the owner) or you will have no coverage.
Easier to prove 'seasoning of title' – when you are the title holder. Easier to refinance.	In some states mortgage brokers and realtors could be fined and/or subject to revocation of their license. It could be considered against their code of ethics to assist a person in violating a clause in a contract (due on sale clause).
If you are on the title you will have long term gains vs. short term if you hold the home for longer than 12 months.	Sellers with lots of equity will be hesitant or completely against giving the deed. Sellers who get legal advice will almost always be against giving the deed to their home. Attorneys tend to be conservative.
<b><u>Lease Option Pros:</u></b>	<b><u>Lease Option Cons:</u></b>
You don't have to buy later – if the market drops or there is something wrong with the home. You can get out! If it goes up you can exercise and purchase the property. If the market stays flat you will have a choice of what to do.	Title is NOT in your name – seller could screw it up – must be careful to screen the seller. Only option from strong sellers, not those in trouble or headed for trouble. (unless you put the deed in a land trust)
More sellers will do an option vs. giving up a deed – especially on 'pretty' homes.	You will have short-term capital gains vs. long term if you are not on the title. This can be avoided if you finance it with the 12 months of payments (see the pros) and get on the title and hold it for 12 months before closing with your tenant buyer. This is a minimum of a 24 month solution.
After 12 months of payments there are many lenders that will treat a lease option as a refinance – as if you were on the deed. It would be treated like a land contract or contract for deed refinance.	Some sellers might feel like an 'option' is not closure on their home. Some sellers will feel better with a deed being transferred or a lease purchase (which is a guarantee vs. an option).

## Featured Speaker Article

A way to get nicer homes. It is more likely the seller that is not behind has taken better care of their home. This type of seller is also more likely to consider a lease option vs. signing over the deed.	
Seasoning of title will start when you file a memorandum of option or lien of interest. Most lenders will consider this adequate and similar to recording a deed (with the exception of FHA or possibly some other lenders).	
Sellers with lots of equity are more likely to give you the right to buy the home than they are to give you the deed to their home.	Sellers with lots of equity usually want to close and get their equity out.

**Warning:** There are many factors to consider when making an offer with either of these techniques. What is the current market condition for real estate in your area? Are homes appreciating, depreciating, or staying flat? What is the financial condition of the seller? Are they moving up or down financially in their new home? All of these items make a huge difference on how you will structure a deal. I always say, “Strong market – make a stronger offer. Weak market – make a weaker offer”.

Do your research, but if you keep your mind open to new ways of acquiring real estate, you will indeed make more money! Try using Subject Tos and Lease Options.