Is Lease-to-Own a Good Way to Buy a House?

By Mark Henricks

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NEW YORK (MainStreet) — Lease-to-own is something you do with furniture, not a house, right? Not necessarily. Although most people who buy houses do it the old-fashioned way, with a down payment and a mortgage, lease-to-own deals are also common in residential real estate.

Leasing to own attracts buyers who can handle a monthly payment but lack a down payment. It can also be good for people with bad or no credit, as well as people who want to give a particular house, school system and neighborhood a test drive without committing to a big down payment and 30-year mortgage. And if you believe local home values are headed up, it can be a low-risk way to lock in a price now before it gets more expensive.

Lease-to-own, also known as a lease option, requires thinking outside the box. But it can make homeownership a reality today for people who might otherwise be paying rent for years. If the owner is willing, renters may even be able to lease-to-own the place they're staying in now, as well as any other rental. "Every for-rent sign you see potentially can be a lease option situation," says Eric Lloyd, a real estate coach with Salt Lake City-based Professional Education Institute.

Basically, a lease option calls for you to pay a little more than the monthly market rent. The extra is applied to a future down payment to purchase the property. For instance, if the market rent is $1,000, you may pay $1,200, of which $200 is credited the down payment. In addition, you may be asked to pay an option fee of 1% or so of the house value

The amount of the rent and credit are obviously critical items, as is the price at which you will eventually purchase the home - not to mention the duration of the agreement. You should have the house inspected and do a market analysis before agreeing on a purchase price. The lease-to-own contract may specify a term from a few months to a few years, during which time you'll be able to buy the property for the agreed-upon price.

The way it works is, if you pay $200 above the market rent toward a down payment, after three years you would have $7,200 for a down payment. This lets you buy now, at today's prices, instead of after you've saved up for a down payment. Another plus is you don't have to qualify for a mortgage right now, giving you time to repair or establish credit. Without making a big upfront down payment, the buyer has less to lose if the market goes bad. Finally, the seller still pays for repairs and maintenance, as well as insurance and taxes.

Lease-to-own also has risks. "It can be a win-win situation, or alternatively, it can be a disaster," says Paul Purcell, co-founder of New York City real estate brokerage Rutenberg Realty. The big risk is that the buyer will pay extra rent for years and then be unable to buy the property. If that happens, all that extra rent could be lost.

A lease option may not work if the market falls, the house becomes worth less than the preset price and the buyer decides not to buy. Another scenario for failure is if the buyer can't qualify for a mortgage when the contract expires. An unscrupulous or financially unsound seller could renege, or the home could wind up owned by someone else due to unpaid taxes, bankruptcy or divorce. If that happens, again, the buyer is likely to lose the extra rent.

To reduce risk of a debacle, check out the seller almost as if the seller were a buyer. Get a credit report to see if the seller has a habit of going bad on his word. Have the home inspected and research market values to set a realistic purchase price. Carefully assess whether you'll really be able to buy when the time comes. Most lease options aren't exercised, because the buyer still can't qualify for a mortgage.

Do not try to do the paperwork on a lease option yourself. You may need a real estate attorney, a mortgage broker or other expert advice to craft the deal properly. Using the right language to reserve rights to sub-lease and describe what happens if you break the lease can make a big difference if problems arise. Also, lease options aren't permitted in every state, and depending on local regulations, you may be better off with a variant, such as a land contract or lease purchase.

Lease-to-own is a slightly unconventional way to become a homeowner, and it's not necessarily right for every person or every situation. But if you are ready to buy but lack the down payment and the right credit score, or you have nerves about committing to a 30-year deal, lease-to-own could be the answer. "It's a great way to get into something," Lloyd says, "and have minimal risk."

--*Written by Mark Henricks for MainStreet*