A Tangled Web – Dodd Frank and Lease Options

On July 10, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law, and for the first time in history we real estate investors are facing an onslaught of government rules and regulations the likes of which we have never seen. Included in the hundreds of Dodd-Frank Act provisions are rules affecting anyone extending “consumer financing” (either as a homeowner selling a primary residence, real estate investor, or private lender) to be used for the purchase of a residence.

The question that I am frequently asked is “does this include lease options? Are lease options included under Dodd-Frank?”

And therein lays the “sticky wicket.” Dodd Frank doesn’t address lease options specifically. Instead, it addresses “consumer financing” as it applies to the sale of a residence.

A true lease option transaction does not convey title and is not a financing instrument falling under the scope of Dodd-Frank. It is merely a lease and an option giving the right, but not the obligation, for a tenant to purchase the property during the period of the option.

BUT….

I wouldn’t breathe a sigh of relief just yet.

Let me explain.

The potential problem that I see is that some “ticked off” tenant buyer and his attorney will attempt to have your lease option transaction treated as a sale. If THAT gambit is successful, all the rules and regulations of Dodd-Frank will apply.

So, how can that happen?

At this point, I don’t think the Courts have very much on which to “hang their hat.” Dodd-Frank doesn’t go into effect until January 2014, so there are no rulings or precedents on which a jurist can rely. Consequently, I think decisions will be guided by rules or guidelines from other sources, especially IRS Revenue Ruling 55-540.

Revenue Ruling 55-540, 4.01 states, in relevant part, “Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed.”

To determine whether an arrangement is a lease-option or a sale, the IRS examines all of the facts and circumstances surrounding the transaction. Circumstances that suggest a sale include:

* Portions of the rental payments are specifically applied to equity in the property (think RENT CREDITS)
* Title to the property will transfer to the lessee upon payment of the rental payments (ie. Total payments made actually equal the purchase price)

* The amount paid in rental payments is an excessively large proportion of the total sum required to secure transfer of title to the property.

* The taxpayer can acquire title to the property under a purchase option price that is nominal in relation to the value of the property at the time the option may be exercised.

* Some portion of the rental payments is specifically designated or readily recognized as interest.

* The sum of the rental payments and purchase option approximates the original purchase price plus interest and carrying charges.

* The lease requires the lessee/buyer to make substantial improvements to the property.

Keep in mind that no single factor is determinative, and that additional factors not listed above may also influence the result. In my opinion, the Courts will look at these same factors as a basis for determining if your transaction is a true lease and option, or if it is only a “disguised sale.”

So, how can we as investors protect ourselves and reduce the chances that our transaction be reclassified?

Here’s what I suggest:

1. Keep your monthly lease amount near or at fair market rents for your area.

2. NO rent credits! (And if you just cannot live without them, keep them LOW in comparison to the monthly rent.)

3. The option strike price should be at or near fair market value. (And I suggest you document how you arrived at this price.)

4. Do not attempt to pass on SUBSTANTIAL repairs and maintenance to you tenant/buyer. (Leaky faucets and stopped up toilets would be okay..Roof repair and furnace replacement would not.)

Takeaway

A PROPERLY structured lease option will fall outside the scope of Dodd-Frank. Just be prepared to document how you handled your transaction.

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About Bill Walston

Bill is a full time real estate investor and mentor as well as a business and tax strategist who supports his clients in growing, promoting and building their real estate business. His passion is teaching creative business and tax strategies so his students make more money while living a tax deductible lifestyle. You can reach Bill at bill@billonbusiness.net