

PITFALLS OF "LEASE/PURCHASE" TRANSACTIONS

A so-called "lease/purchase" transaction is in effect a method of seller-financing sometimes used when a purchaser does not have a sufficient down payment immediately. It is distinguished from a lease/option in that a lease/purchase contains a binding obligation to purchase, and therefore, constitutes a bilateral contract. The lease/purchase mechanism is preferred by some sellers over an immediate sale by real estate contract or note and deed of trust for reasons that are largely illusory and misplaced.

- 1. Seller's Remedy if Purchaser Defaults.** The common misconception is that the seller can recover possession of the property simply by using the unlawful detainer eviction process if the purchaser defaults. However, the relationship between the parties under a lease/purchase is not merely one of landlord and tenant, but also seller and purchaser. In a 1983 court decision, the Washington Court of Appeals held that "the transaction must be treated as an executory contract for the sale of real estate (i.e. real estate contract) and . . . the ordinary rules governing forfeitures [apply]." *Reed v. Eller*, 33 Wn. App. 820, cert. denied, 99 Wn.2d 1015 (1983). In other words, a lease/purchase agreement is in substance a real estate contract and must be forfeited as a real estate contract. A lease/option, on the other hand, creates only a landlord-tenant relationship until the option is exercised, and thus, can be terminated and possession recovered under the unlawful detainer statute if the tenant defaults.
- 2. Due-On-Sale Clause in Underlying Loan.** Contrary to popular belief, a lease/purchase *does* trigger the due-on-sale clause, if there is one, in the underlying loan upon *execution* of the lease/purchase agreement, not upon *closing*. 12 C.F.R., 591.2 (b), 591.5(b). The same is true of a lease/option.
- 3. Excise Tax Liability and Penalty.** Excise tax is due upon execution of the lease/purchase agreement, not upon closing or recordation. WAC 458-61-030(12). Interest and substantial penalties are imposed for late payment. Under a lease/option, excise tax is not due until the purchase option is exercised.
- 4. Income Tax Considerations.** A "sale" is generally deemed to have occurred for income tax purposes on the date that title is transferred *or* on the date that the purchaser takes possession under a binding contract to purchase. Thus, the execution of a lease/purchase agreement constitutes a "sale," whereas the granting of a lease/option does not. If the sale is subject to depreciation recapture, the seller may incur a substantial tax liability in the year of sale, yet not have received sufficient funds to pay the tax. The timing of a "sale" is also important for purposes of deferring gain on the sale of a principal residence.
- 5. Protection of Purchaser's Interest.** Lease/purchase agreements typically are not recorded. As a result, although the purchaser's possession of the property ordinarily gives constructive notice to subsequent purchasers or encumbrances (precluding *bona fide* purchaser claims), if the seller files for bankruptcy the trustee in bankruptcy can reject the lease/purchase agreement and oust the purchaser from possession of the property. One would not even think of not recording a deed or real estate contract, so why not record the lease/purchase agreement or a memorandum thereof?
- 6. Conclusion.** Because of the hybrid nature of the lease/purchase transaction, there are significant uncertainties and pitfalls associated with the devise. It is preferable to structure the transaction as a lease/option, or an immediate closing on real estate contract or note and deed of trust with a short-term balloon payment.

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