What is Rent-to-Own?

Rent-to-own agreements are when prospective homeowners arrange to rent a house with the option (or obligation) to buy it later.

If you're interested in owning a home someday but aren't financially ready right now, renting to own could be a good first step. The process can afford you extra time to boost your credit score or lower your debt-to-income ratio as you prepare to qualify for a mortgage loan. But it's important to consider it carefully, because renting-to-own may not be the most cost-effective way to purchase a home.

Read on to find out if renting to own is a good idea for you. We'll look at the two types of rent-to-own contracts, as well as the pros and cons of signing. We'll also go over the potential risks of entering these types of agreements and ways to avoid them.

Who is rent-to-own for?

Renting to own could be a good choice for prospective homeowners with good income, savings and the ability to become mortgage-eligible within 2 to 3 years. "They're best for someone who has everything it takes to get a mortgage except a good credit score or, perhaps, a high debt-to-income ratio. Renting to own costs a little bit more, but it'll get them where they want to be," says Realtor Jim Miller of Keller Williams Realty Elite's Homes4OK.com.

Higher costs aren't the only potential downsides associated with the rent-to-own process. "You have to go into it with your eyes open. That's the number one thing I would recommend to any client considering this," Miller says. Below, we'll look at the two types of rent-to-own contracts, as well as the pros and cons of signing. We'll also go over potential risks and ways to avoid them.

How does rent-to-own work?

There are two types of rent-to-own contracts. The main difference between the two is the flexibility of the terms.

Lease option agreements: These are when you're given the right to buy the home at the end of the lease term, but purchasing is not required. If you decide against buying the property, the lease expires normally, and you move out.

Lease purchase agreements: This type of rent-to-own contract legally obligates you to buy the property when the lease ends.

These deals can be done between tenants and individual homeowners or between tenants and companies. Either way, there's usually a one-time, upfront fee involved. Sometimes called the option fee or deposit, the amount can be anywhere from 1% to 10% of the home's purchase price. While they're typically negotiable, Miller says 10% option fees are common. Option fees are also usually nonrefundable.

What does a rent-to-own agreement usually include?

The rent-to-own process is similar to a traditional rental or purchase process. Once you find a rent-to-own property, you'll sign a lease option or a lease purchase agreement.

Both types of rent-to-own contracts are formal legal documents that will specify:

1. **Agreement terms**
   Your contract must state whether you'll have the option versus obligation to buy the home at the end of the lease. It should also tell you the lease term's length. Typically, rent-to-own lease lengths last between 1 and 3 years, but that can be negotiable.

2. **Purchase price**
   In some cases, you and the seller will agree on the purchase price when you sign. In others, the contract will tell you when and how the purchase price is determined. "If you work out a deal where you're agreeing to buy the house at today's price 2 years from now, that could really work in your favor because property values usually grow, and you'll end up with a bunch of equity," Miller says.

3. **Rent**
   You'll pay rent during the lease term. The contract will specify the amount and whether a portion of each payment will be applied to the future purchase price. "You want to look for things like this because it tells you that the seller knows what they're doing but they also have a heart and truly care about making this process work for people," Miller says.

4. **Maintenance and other special clauses**
   In a regular rental agreement, repairs and maintenance are usually the landlord's responsibility; rent-to-own agreements can differ. You'll want to read the contract carefully to determine your responsibilities. The contract should also state whether or not you're responsible for costs like property taxes and insurance fees.

5. **Lease-end terms**
   Depending on the type of agreement, you'll either be required or given the option to buy the property when the lease ends. Either way, the contract should be clear about what happens next. If you sign a lease purchase agreement, you'll be responsible for making the purchase, whether in cash or by securing a mortgage loan. If you're unable to get the loan or otherwise unable to make the purchase, you could face legal action.

Crunch the numbers

Let's say you're interested in entering into a 3-year rent-to-own agreement with an individual seller for a $250,000 home with a 10% option fee. Your monthly rent is $1,500, and $250 of that will count toward your future down payment.

At signing, you'll owe the option fee of $25,000. This will usually be held in an escrow account until the lease ends. During the lease term, you'll pay $54,000 in rent, $9,000 of which will apply to your down payment. At the end of the lease term, you'll have $34,000 to use toward the down payment if you decide to buy the property.

Is rent-to-own a smart idea?

Well, it depends. Like with any legally binding contract, entering into a rent-to-own agreement carries risks.

Pros:

- If you have limited savings, there are opportunities to save for a down payment built into the agreement.
- Since leases typically last between 1 and 3 years, the process allows extra time to qualify for a mortgage by raising your credit score or lowering your debt-to-income ratio.
- If you agree on a purchase price at the time of signing based on the home's current market value, and the value has increased by the end of the lease term, you will have gotten a great deal. "We very rarely see negative growth in property values, so this is something to keep in mind," Miller says.

Cons:

- The monthly rent is usually higher than rates for a regular lease.
- If the home's market value is lower at the end of the lease term than it was at the beginning, you could lose money if you decide to buy it.
- If you decide not to buy the house at the end of the term, you could lose your deposit or face legal action for breaking the contract.
- The risk of scams is higher than in the traditional rental/purchase process.

Why is rent-to-own risky?

There are several risks associated with the rent-to-own process, such as the possibility of losing the option fee deposit or paying over a home's market value when making the eventual purchase. The risk of scams is also higher with this type of real estate transaction.

Common rent-to-own scams (and how to avoid them):

Scam: The purchase price written into the contract is way over the home's fair market value, meaning that when you buy it, you may owe more on the mortgage than the home is worth.
How to avoid: Look at similar homes in your area and compare sale prices. Working with a knowledgeable real estate agent in your area can help.

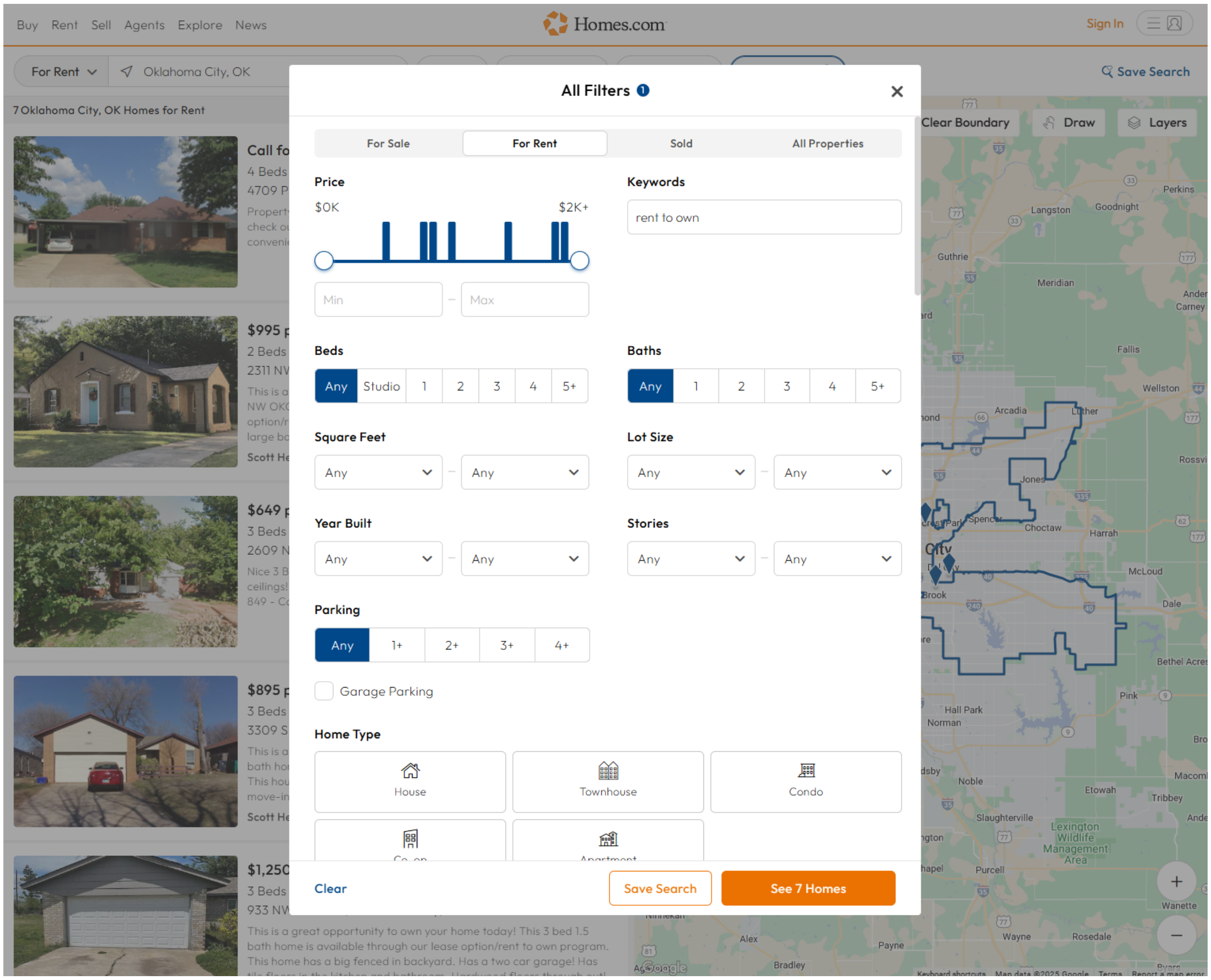
Scam: The property is in worse shape than advertised or has issues like asbestos, lead, mold, water or foundation damage that weren't disclosed by the seller upfront.
How to avoid: Before signing, hire a professional to do a home inspection. They'll check the house for major problems and safety hazards.

Scam: The seller isn't actually the owner of the home.
How to avoid: Before making any payments, verify the owner. That information is often available online, but you can also ask the seller to provide proof of ownership, like the most recent tax statement, the deed or mortgage documents.

How to find rent-to-own properties on Homes.com

Rent-to-own transactions used to take place almost exclusively offline, but these days, the process is largely digital. On Homes.com, searching for a rent-to-own home is as simple as normal house hunting.

1. Visit the Homes.com search page.
2. Type in the neighborhood, city or state where you want to live, hit enter, then navigate to the "All Filters" button.



3. In the "Keywords" box, type "rent to own," then click "See Homes."
4. Contact the listing agent and get started!

Tips for rent-to-own transactions

As with any real estate transaction, renting to own involves both risk and reward. If you're still saving for a down payment, building good credit or working on lowering your debt-to-income ratio, it can be a smart first step in becoming a homeowner.

Before entering into a rent-to-own agreement, it's important to:

- **Do your homework**
  Knowledgeable local real estate agents can shoulder much of the research burden, so consider working with a realtor experienced with these types of transactions.
- **Read the fine print**

Reading the contract thoroughly is the best way to ensure you’re not hit with any surprises after signing.