Master Leasing -
Another Tool In Your Toolbox

PANEL DISCUSSION PRESENTED BY:

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1. ***Increase your income by 15 percent.***
2. ***Have more control over the properties you manage.***
3. ***Get out from under the fiduciary relationship you have with clients.***

SOUNDS IMMORAL, ILLEGAL, AND FATTENING?

Nope! We'll tell you why and how, using the system presented here!

I. Definitions

Master Lease (from BusinessDictionary.com) - Controlling lease under which a lessee can sub-lease the property for a period not extending the term of the master lease. (from Answers.com) Controlling Lease; contrast with Sublease. One cannot grant a greater interest in real estate than one has; so if a master lease is for a five-year term, a sublease cannot legally exceed five years.

Sandwich Lease (from InvestorWords.com) - A leasing arrangement in which an entity leases property from one party and leases that same property to another party. In this arrangement, the entity is both a lessee and a lessor, so it both pays and collects rent on the same property. (from *Answers.com*) - Lease held by a lessee who becomes a lessor by subletting. Typically, the sandwich leaseholder is neither the owner nor the user of the property.

A master tenant is always a sandwich tenant because he maintains a sandwich position between the owner and one or more sub-tenants. A sandwich tenant, on the other hand, may or may not be the master tenant depending upon the number of leases that are "stacked" upon the property and his position within the "stack."

II. Basic types of Master or Sandwich leases

A. Performance lease

Sandwich tenant pays a percentage of the rent that he receives only if and when he receives it. Generally the owner covers all (or most) of the à la carte expenses.

B. Fixed lease

Sandwich tenant pays a guaranteed rent whether or not the property is occupied. Operating expenses are negotiated between the owner and the sandwich tenant as part of the lease.

C. Hybrid lease

Sandwich tenant pays a guaranteed minimum rent and additionally a percentage of any rent he receives from a sub-tenant.

III. Similarities and differences between Fee Managers and Master Tenants

A. Source of income

Both generate income because of their contractual positions between owners and occupants (or sub-lessees). They both collect rent and remit rent to owners.

B. Relationship to property owners

Fee managers act as agents (or transaction brokers). Since an agency contract authorizes a fee manager to act for the property owner and since they are in business to make a profit there is a potential for financial abuse. The manager's desire to maximize his fee income can be in direct conflict with the owner's desire to maximize his net rental income. In many cases the owner lives in another location and trusts his fee manager to make all decisions on his behalf. This is why most states regulate fee managers through licensing law. Most fee managers offer a standard management contract (*their standard*) and do not allow owners to make modifications to the contract.

Master tenants act as principals in every transaction in which they are involved. A master tenant has no authorization to act for a property owner other than the right granted in the lease he negotiates with him. The master tenant is never the owner's agent. An owner and master tenant will only enter into a contract if each feels they benefit from the transaction. Since both are principals, licensing regulation does not apply. Master tenants tend to be more entrepreneurial than fee managers since each lease they negotiate may necessitate different terms if a transaction is to take place.

C. Vicarious liability

Fee managers expose their owners to vicarious liability because of their employment agreement. Master tenants do not since they are leasing and sub-leasing property on their own behalf and are not employed by the owner.

D. Active Participation

Owners "actively participate" in renting their properties to their master tenants. It is more difficult to prove "active participation" if a fee manager is involved.

E. Tax audit profile

An owner's tax audit profile appears lower when a master lease is executed in lieu of a management agreement. This assumes that the owner's net rent received after expenses is the same figure.

IV. Benefits to Master Lessee

A. Provides income

As rents increase your income can also increase. You are borrowing real estate from an owner and leasing it to others to generate income and/or profit.

B. Capital rarely needed

A performance lease requires payment to the landlord only when rent from a sub-tenant is received, whereas a fixed lease usually requires some payment whether or not you have an occupant who is paying you. Since you negotiate both leases and control document preparation, your contracts are pro-tenant when acting as a tenant and pro-landlord when a landlord (see item (Q) below). This means that you can obligate the owner and your sub-tenant to cover most expenses.

C. Little or no start-up costs

You can grow your business one master lease at a time. This business does not require employees, much equipment or an office. All you really need is a computer, word processing and accounting software, a printer, scanner and a cell phone.

D. Control property without ownership

Master leasing gives you income and control of the property. It can transfer many ownership rights to you without forcing you to take on debt. If real estate prices continue to fall it does not impact you. If rents fall and you want to terminate a master lease you can invoke the escape clause that you presumably drafted into that document. It is much easier to terminate a lease that you have drafted than to get out of title in a bad market.

E. Get to test drive properties before buying

Sometimes a property looks like it will make a great rental, but for whatever reason it does not. A master lease allows you to determine if the property meets your long-term income needs before you negotiate any further with the owner regarding a purchase.

F. Easy negotiation

The master lease is a relatively easy negotiation with an owner. The owner has a problem that you can solve by filling an empty house and "losing them less" than they are losing without your help. This first negotiation gives you the opportunity for further negotiations. I have found that if I under-promise and over-perform, owners look forward to further negotiations. I have multiple properties that I have purchased in this fashion.

G. Works in any market

Property values do not impact what you will pay in rent. If you have a performance lease you will only pay a percentage of what you collect. If you negotiate a fixed lease you will start with your opinion of market rent *(it is imperative that you understand how to price rentals and manage tenants before attempting a fixed sandwich lease*), then deduct for management, vacancy and maintenance costs. Once you have determined this net figure you should additionally deduct a figure for profit. Negotiate lease terms adjusting your offer depending upon the amount of time you can control the property. There is greater risk in executing fixed master leases, but there is a much greater profit potential if you understand and can control that risk.

H. Limits liability

If you create the documents (or have them created for you) you can control much of your liability. You can create an escape clause if you ever need to terminate the lease, a stop loss for your share of monthly maintenance expenses, a requirement for the owner to add you as an additional insured on his insurance policy. You do not have to sign any recourse debt to acquire a master lease. A master lease is a low profile asset. You are not listed as the owner in the public records. When drafting contracts for sub-tenants you can pass your expense stop loss from your master lease to their sub-lease (make sure you can always terminate your sub-leases faster than your master lease can be terminated).

I. Favorable tax treatment

Income derived from a master lease is passive income and not subject to self-employment tax.

J. No competition

I have never had any competition in this business. Property management companies trip over each other to generate new business. A master tenant has more tools in his tool box to solve problems. He can make guarantees that managers cannot make and he doesn't have to use a "one size fits all" approach when negotiating with an owner.

K. Little licensing regulation

A master tenant never acts as an agent when leasing a property from an owner or to an occupant. Agency relationships generally require a state license and regulation to protect the public from unscrupulous or incompetent people (a few states like Texas do not require licensing for property managers). A master tenant is always a principal to each lease that he signs and he has no fiduciary relationship with either the owner or occupant. A master tenant must negotiate all contracts on his own behalf (unless he hires an agent to negotiate for him).

L. Financial privacy

Since the holder of a master lease is not the legal owner of the property, it is very difficult to determine the number of properties he controls. We have secured some valuable master leases to properties using trust deeds (or mortgages depending upon where you live), but even then you blend in with all the other lenders and are not easily found.

M. Negative cash flow property can provide you positive cash flow

You must qualify owners who lease you their property. You should deem them willing and able to pay their mortgage payments, property taxes and property insurance before you commit to leasing their property. Their negative cash flow does not impact your ability to lease and sub-lease their property for a profit, since you will build cash flow into your contracts and only promise to lose them less than they are currently losing by maintaining an empty house.

N. Can contract long-term

Master leases can run for years. The internal revenue code treats a lease longer than 30 years as ownership of the property and allows depreciation to be taken. I leased a house in 1985 for $375 per month for a term of 35 years.

O. Works with the best rental houses

When starting out with limited resources most investors can only buy properties from a "don't wanter" who will make them a deal, not realizing that they will have to make the next buyer a deal when they become a "don't wanter." Master leasing, on the other hand, allows you to lease the best possible rental properties in great neighborhoods since you will (usually) pay less rent than you will receive.

P. Interest rates don't affect your income

When master leasing you are not financing a purchase or taking title to a property subject to existing debt. Your only concern with financing is whether or not the owner will be able to meet his mortgage obligations (assuming the property is not free and clear).

Q. Flexible documents

Master leasing gives you control of all documents since you create the documents for both the owner and the sub-tenant. This is very different from most real estate situations where there are third party lenders, title companies, escrow companies, brokers, etc. who all have their own inflexible paperwork which they want you to execute. With master leasing you can and *must* tailor each of your contracts based upon the negotiations you have with property owners and your sub-tenants.