The Advantages of Purchasing Properties On Subject To

There are a number of advantages to purchasing a home “subject to” from a previous owner. The most obvious advantage is that you do not need to apply for your own financing. If the previous owner had a good interest rate, their rate will typically be lower than the rate that you would be able to obtain as a new owner. The biggest reason for this is that their rate is based on a primary residence and it will carryover to you.

Besides a lower interest rate, you will typically avoid all the closing costs associated obtaining a new loan. If you are buying the house subject to, you may be able to obtain the house for no money down; sometimes the seller will pay you to take over the mortgage. In these scenarios, you are definitely better obtaining a loan subject to than you are obtaining your own financing.

Are there reasons not to take a loan subject to? If their interest rate is higher than your APR would be on a new loan, and if you do not have a limit to the amount of loans that you can obtain, you may be better off getting a loan yourself.

Here is where I think a subject to, does not make sense. I have heard a lot of people tell me that they are better off getting a house for a 15% discount because they took over the seller’s loan, and thus have eliminated all the risk of investing in real estate. They think that they are better off getting a house at a 15% discount subject to than they would be getting a house at a discount of 30% where they had to use their own credit. I have trouble figuring out how they reached this conclusion, but let’s explore an example.

Let’s assume that the house is worth $100,000. They bought the house for $85,000 subject to, and I bought the house for $70,000 and had to get my own financing. Let’s assume that they took over an interest only mortgage at 5.5% and sold the property after one year for $100,000. For the sake of simplicity, the house was sold outright after a year with no tenant in the house. In their scenario, they had to pay a total of $3,850 interest. After spending $1,200 in taxes and $500 in insurance. (Please note that their insurance agent may have advised them to pay for two insurance policies. One insurance policy that covers the previous owner and another that covers their liability).

For the sake of this example, let’s assume that they didn’t even have to pay for that. In their scenario, let’s assume that typical closing costs and the other holding costs totaled $5,000. Their net profit on this transaction is $4,950. That is assuming that they actually sold it for full price.

Let’s take the same example, but I bought the house for $70,000 and had to obtain my own financing. I paid cash and then refinanced with a 12 month note. My interest rate was 7.5% with $500 in closing costs. In this scenario, I pay a total of $5,250 interest and $500 in closing costs. Thus I paid $1,900 more in financing fees than the person who bought the house. I have all the same closing costs, holding costs, taxes, and insurance upon the sale. In my example, I made a net profit of $17,550. Thus I made $12,600 more than the person who bought subject to.

You might say that this scenario is not a fair comparison because we may have to hold the property for longer than a year. I hold my properties for an average of 8 months; on average I will do even better, but let’s say that in this example, it takes us four years to sell the property. After my year is up I have to refinance to a 30 year fixed mortgage and it costs me $3,000 to do so.

In this scenario, I am ahead $12,600 after year one. At the end of year one, I have to buy the new mortgage, so I am now only up $9,600. For each additional year that I hold the house, I will pay an additional $1,400 in interest than the person who bought the house subject to. You may have done the math and figured that I had to pay an additional $1,700 per year, but remember my loan amount is only $70,000 whereas the subject to buyer has a loan amount of $85,000.

We are under the assumption that the person who bought the house subject to did not, in fact, have to pay for the second insurance policy. After paying an additional $1,400 in interest per year for the remaining three years, I am still ahead of the subject to purchase by $5,400. It would take 7.85 years of us trying to sell the property before the model of subject to that I have presented would be better than my method of buying at a deeper discount and obtaining my own financing.

If I am buying a property with the purpose of reselling, it should not take me an average of 7.85 years to sell. However, if I know that I will be keeping this as a rental, and if the sellers are okay with keeping the mortgage for well over 7.85 years (I say well over 7.85 because that is just the break even point. In order for it to work better, I would have to keep it for much longer than this to become a benefit), and if I'm not obtaining the second insurance policy, an argument could be made that I'm better off buying the second subject to.

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