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The Guru Is In

Inventing Rent-To-Own

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December 1, 2025 11 min read

As kids, we grew up believing that if we wished for a thing hard enough, Santa would deliver it — and so it is today with proponents of rent-to-own (RTO). The name makes it sound like a perfect gift to find beneath the tree, but despite all that wishing and hoping, it has yet to appear as a viable program.

With "housing affordability" having gone viral in the realm of wider public discourse, cities and states have belatedly recognized the gap in their housing delivery: between the highest new affordable rental and the lowest market homeownership lies enormous effective demand. States and cities also tacitly acknowledge that the gap is widening, it's the cities' own fault, and addressing it head-on requires municipal political courage that's hard to come by. So, instead of acting, they wish and wish harder.

Rent-to-own versus Buy-to-Rent (B2R) and Earned Equity Program (EEP)

RTO differs in material ways from the buy-to-rent model pioneered and dominated by Invitation Homes, where rents and home resale prices track the market and it's entirely up to the renter household to make the running to achieve homeownership.

RTO also differs in its financial structure from Arrive Home's Earned Equity Program (EEP) that I profiled a few months ago, which is designed for a different customer type. The EEP financier is making its returns on the spread between its cost of FHA-insured capital and the imputed interest rate and fees it's earning from the loan-equivalent payment stream. EEP's costs to the household, and its allocation of the risks and consequences of early exit, are less favorable to the household than RTO's.

Against these limitations, EEP has one huge advantage: it exists, and RTO doesn't (yet).

This result of all that wishing is that instead of rent-to-own, we are actually experiencing rent-to-pretend. Household tenants-cum-future-owners pretend that their family's income will soon rise enough to making buying a home feasible, and owners-cum-landlords pretend to believe this, all the while charging market rent.

Wishing is not a strategy: financial and subsidy structuring is. To make RTO work, as both a business model and an affordability promoting tenure model, requires financial structure for program participants, and economics for both worthy households and capital providers, that solves two problems:

- *The demand-side social problem*: Households' income and assets have to rise fast enough to catch up with homeownership feasibility.
- *The supply-side delivery problem*: Homes available first for affordable rent and then later for affordable purchase by the sitting household have to be delivered into the supply.

This requires the right economics, participants, expectations, motivations, and transaction structure.

Economics. RTO as a program starts with an economic lemma:

$$P\% = R\% + S\%$$

RTO renters will be paying a higher percentage (P%) for the sum of rent (R%) and savings (S%) combined than they would as normal renters who are not pursuing a pre-agreed option to buy the home they now occupy.

In this, savings (S%) matter crucially. Not only do people value only what they pay for, savings are also the ultimate pre-loan proof of persistence toward a longer-term objective — whereas, if the RTO payment were no higher than normal, everyone would sign up for it without making any commitment to sustain savings; the dropout rate would be high and the owners' motivation to become RTO landlords would vanish.

How much an RTO household chooses to save every month can be a program-design variable, but that they are committed to meaningful regular savings atop paying their rent is a foundational prerequisite.

Participants. Like other forms of affordable housing, RTO is a double-bottom-line program. As such, like other affordable housing, it takes not two to tango, but three:

1. *The household.* A family that wants to buy a particular home, will move into it now, and will pay rent over the course of many years. Most importantly, the family will have a strategy and plan, stretching months and years into the future, (a) to raise its family's earning power in real terms (i.e. faster than inflation) and (b) to save up the down payment to buy the home.
2. *The encouraging and self-sunsetting landlord*. A professional manager (often in multi-unit buildings) that will be responsible for renting and leasing, rent collection, operations and maintenance, enforcement if required, and re-renting (if the household moves out). Importantly, this landlord will enter into leases knowing

most of its tenants move in expecting to move not out but up, to being owners. If the program succeeds, therefore, the landlord will be putting itself out of business, one home at a time.

3. *The benevolent financier*. A capital provider with mission motivation that obtains the home in the open market (builds or buys), and instead of selling it today, offers for RTO not with the primary goal of maximizing rent, but rather of facilitating its sale to the RTO household at a price that will rise by some formula intended to make it attainable.

Expectations. Each party has particular and non-market expectations of the other two.

The household expects to buy one day, and to do so by financing its purchase like any other home buyer, with a combination of down payment and third-party home purchase loan. To qualify for that future loan will require higher real income than the household has today, and a down payment that today the household lacks. The landlord expects this to happen and needs to see every such conversion as a success, and the financier expects to be put out of the rental business by selling off its property one home at a home.

Delivering on everybody's expectations is possible only if the household is *paying more than normal rent*, with each payment being the combination of rent plus savings. Mechanically, if the initial rent is set at (say) the standard 30 percent of target household income, the RTO payment could be (say) 35 percent of income, with the extra five percent being diverted into a Homebuyer Savings Account (HSA).

The HSA account would act akin to an IRA or §401(k) retirement plan, where money contributed would be held by a trustee and invested, accreting every month and building up over time. Like a §401(k), it could be combined with an employer contribution if the employer is acting as part or in concert with the benevolent financier. (If the family exits early, presumably the money saved goes back to the departing household, and an incoming household restarts the clock with a new P% payment.)

"Yes, but will the numbers work?"
A reader feedback opportunity

While researching and writing this article, I built an Excel model to explore the impact of different home prices relative to household income, different levels of normal rent (as a percentage of income), RTO payment, and PTI homeownership payment. The results are intriguing, and they are market- and financing-dependent. If you have a live or hypothetical case you'd like to explore, email me at dsmith@affordablehousinginstitute.org and we can run the model.

Meanwhile, for the economics to work, the household's income needs to rise in real terms (i.e. generally faster than nominal inflation) and the home's future price needs to rise in nominal terms at a rate slower than the household's. That future appreciation rate either has to be capped by contractually agreed multi-year fixed formula, or linked to an index (e.g. CPI-Urban) that isn't expected to outpace inflation. If not, even after the down payment has accumulated to the 10 or 20 percent necessary to catalyze the home-purchase loan needed to complete the buy, the household won't be able to afford the future home purchase loan needed to buy the future-priced home.

Finally, even after homeownership, the higher percentage-of-income payment is likely to persist a higher payment-to-income (PTI) ratio, because that's what happens in the real world of homeownership.

Motivations. For the economics needs and the necessary participant behaviors to be aligned over a multi-year period, we need participants with the right motivations that themselves are aligned for the duration of the rental tenure. If not, the inevitable divergence among growth rates (household income, market price of a home, local rents) will throw out of whack the eventual economics of RTO renter stepping up to becoming an owner.

For this, each group needs to be pre-screened and pre-qualified:

1. *The future-ownership household* needs to be (a) aspirational, (b) young enough to be in the rising wave of employability and salary expectation, (c) old enough to be ready to put down roots in a community as if already homeowners, (d) mature enough to commit emotionally to multiple years of saving, dedicated enough to do it month by month, and (e) patient enough to stick with it even if the household's upward path is bumpy. Screening and pre-move-in financial literacy training are likely musts.
2. *The self-sunsetting landlord* needs to be used to working with double-bottom-line capital providers, comfortable with reporting transparency, income verification, and regulatory oversight, and familiar with renting to the target household types. In short, the landlord must have come from the affordable housing sector, rather than immigrating in just for this type of tenure model. Beyond this credential, the landlord has to be comfortable with working itself out of a job, because the endgame is homeownership. Put it all together and the ideal landlord/manager would be one that straddles affordable rental and affordable homeownership (e.g. limited-equity co-operatives or condominiums).
3. *The benevolent financier* needs to buy a home intending to resell it, not for the maximum profit, but for a price that is plausibly within the future grasp of an RTO household that cannot afford it now and whose income will have to outpace inflation for years. At the same time, the financier needs to be ready to rely on the household's savings to rise to reach the eventual down payment requirement. The financier will also either (a) itself be the custodian of the household's savings or (b) have had a say in who or what the custodian is, and will have some kind of transparency rights to track the household's progress toward bankability. This implies the financier is a professionally managed entity, with (a) long-term repayment horizons, (b) enough balance sheet and liquidity to tolerate the uncertainty of when a household might flip from renter to owner, and (c) willingness to accept the interim rental yields, even while restraining rent increases consistent with the original program. Again, financiers already active in affordable housing will be the most natural ones for RTO.

Casting our play. If this is to be a business, it needs players.

The RTO renters are easy to cast and there are multitudes of them.

The self-sunsetting landlords can be cast from the ranks of mission-oriented property managers, many of them non-profits, and particularly those that are both managers for affiliated long-term owners and for resident-controlled entities such as co-operatives and condominiums.

But what of the financiers? In many ways they'll be the critical players, putting up capital, stretching across tenor or maturity mismatch, and overseeing the gradual transformation of renters into homeowners. They're the players who matter most, and both large non-profit Low Income Housing Tax Credit (LIHTC) owners and large non-profit LIHTC syndicators are ideally positioned to play the role … if they wish to audition for it.

Policymakers have been hoping for renters to convert to owners for at least three and a half decades, dating all the way back to HUD Secretary Jack Kemp's insistence upon adding a resident homeownership conversion option into what would be renamed into the Low Income Housing Preservation and Resident Homeownership Act (cf. Section 226 et. seq.). The RHA half of that statute's name never sprouted because it was never resourced, and by the time LIHPRHA was over, the Low Income Housing Tax Credit (LIHTC) was dominating the space and the industry was settling comfortably into a model of syndication, then Year 15 resyndication, and self-perpetuating extended rental.

Locking LIHTC households out of future ownership doesn't have to be the case. As far as I know, nothing in Section 42 prevents a post-Year 15 LIHTC property from offering RTO by selling itself to a newly formed limited-equity housing co-operative. This doesn't run afoul of Section 42 because co-operatives are legally rentals, owned by a corporate landlord whose shareholders gain the right to occupy stated flats at rents set by the co-operative. The feasibility arithmetic will depend on circumstances, and the purchase might need to be catalyzed with a Program Related Investment from the non-profit sponsor or syndicator, or from a motivated state or city agency.

Launching RTO via Year 15 LIHTC properties would mean eschewing the established paradigms, doing new underwriting, maybe finding some capital resources, and reinventing the owner's/syndicator's relationship with its current tenants and potentially future owners. It takes work and pioneering and undoubtedly entails some risk.

But it's your mission, folks. Why not do it?

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