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Making Mortgage Lending a Family Affair

By JENNIFER SARANOW SCHULTZ

MATT RADO is in the market for his first home, but the 41-year-old in Santa Ana, Calif., does not plan to get a [loan](#) from a bank. Instead, Mr. Rado, who works in sales for a technology company, plans to have his retired parents lend him the money.

The idea behind the lending strategy is this: Mr. Rado, who is preapproved for a 30-year fixed [mortgage](#) at about 4.75 percent from a commercial lender, will get at least as favorable a rate from his parents along with lower closing costs. At the same time, his parents will get a higher rate of return than is offered by a traditional savings vehicle like a savings account.

In addition, the mortgage payments will function like the annuity like [investments](#) that Mr. Rado's 71-year-old father had been considering. "I just feel better about the money going to my dad as opposed to going to some bank," Mr. Rado said.

With credit tight and interest rates at historic lows, such intrafamily loans can be a win-win for parents and children. "It's an absolutely terrific time to make an intra-family loan," said Carol G. Kroch, head of wealth planning for [Wilmington Trust](#).

Such loans, whether for a home, car or education, are essentially family **bonds** that could protect money from risky behavior by others.

Rick Kahler, a **financial adviser** in Rapid City, S.D., who has experience in the real estate industry and is the author of four books on financial planning, said such loans could potentially deliver higher returns than a double-A-rated 10-year corporate bond, which he said was returning about 4 percent; a triple-A bond, which he said was delivering around 3 percent; or a certificate of deposit, which has rates that are even lower. Still, he said, the intra-family loans are much riskier than such investments, and so are not necessarily equivalent to them. With an intra-family loan, parents are betting that their children and their children's significant others will have the income to repay the loan. And even if the children have excellent **credit scores** now, their status could change drastically — much faster than a corporation's — if a job loss or illness were to occur. To help lessen these risks, financial planners have specific recommendations about who should make and get such loans.

With all the news about faulty foreclosures, “even a dysfunctional family could look like a financial refuge right now,” said Deborah L. Jacobs, author of the book “Estate Planning Smarts.”

According to the 2010 **National Association of Realtors** Profile of Home Buyers and Sellers, to be released on Friday, 9 percent of first-time home buyers received a loan from a friend or relative this year to help with down payment costs, up from 6 percent last year and a record high since the survey began.

That is still a much smaller percentage than those receiving gifts of money from friends or relatives. The association attributed the increase to more parents trying to help children take advantage of the home buyer's tax credit.

The following are tips for families considering intra-family loans.

HOW IS THE FAMILY SITUATION? Financial planners say such loans are good options for parents who have enough money in the bank to comfortably make the loan, want a safe and secure investment and want to earn a higher rate than offered by C.D.'s, Treasuries or corporate bonds. Such loans are also good options for parents who may not have enough money to give outright to their child or don't want to spoil their grown children with gifts.

Intra-family loans probably aren't right for parents who "have a lot of opinions about the lifestyle of their children" because a loan could make them become overly critical of the grown child's spending habits and potentially damage the parent-child relationship, said Lauren Locker, a certified financial planner at Locker Financial Services in Little Falls, N.J. Instead, she said, such parents "may want to give the money."

THE BANK LOAN QUESTION Most financial planners recommend that parents make such loans only to children who would receive a loan on their own from a commercial lender.

While parents may be able to give their adult children a lower interest rate than the bank, “the family is taking too much risk to lend to someone who can’t get bank approval,” said Donald Martin, a certified financial planner with Mayflower Capital in Los Altos, Calif.

A loan to a child unable to get a bank loan, planners say, is more likely to be a bad investment with a greater chance of default. In such circumstances, gifts are a better idea.

For parents, “you are engineering a dilemma where you will need to ask yourself if you will foreclose or forgive the loan,” said David H. Diesslin, a financial adviser and owner of the financial advisory firm Diesslin & Associates in Fort Worth.

SETTING UP THE LOAN To avoid tax consequences, the parents will need to charge an interest rate for loans with a set term that is at least what the government’s applicable federal rates are at the time the loan is created.

The [Internal Revenue Service](#) sets the rates monthly for short-term loans (like loans to pay off credit debt), intermediate-term loans (like car loans) and long-term loans (like mortgages) with various compounding periods. For November, for instance, the long-term rate for loans over nine years was 3.35 percent, the midterm rate for loans of three to nine years was 1.59 percent, and the short-term rate for loans of up to three years was 0.35 percent, according

to Ms. Kroch of Wilmington Trust, who said those rates were near historical lows.

WATCH THAT GIFT TAX By charging at least the applicable federal rate, parents lower the risk of gift tax and other tax consequences. For 2010, a person can give up to \$13,000 annually per recipient without paying gift taxes. But any gift above that amount requires the filing of a gift tax return and counts toward the \$1 million limit people are allowed to give tax-free during their lifetimes. If the government recharacterizes a loan as a gift, the amount transferred would count toward that \$1 million and could affect other gift and estate plans.

To make sure the money is considered a loan and not a gift for tax purposes, experts also recommend that the loans be documented as formal promissory notes that state the terms of the loan, including repayments, the interest rates and what will happen if the loan is not repaid. Mark M. Gleason, a senior financial adviser with the Wescap Group in Burbank, Calif., also recommended that the lending family member “be prepared to write off a substantial part of the loan if things don’t turn out well — just like **banks** have been doing the last few years.”

Financial planners say the formal structure also can help lessen the chance of loan-related family strife if the lender were to pass away. “With the right documentation, the money is treated as a loan when splitting up the estate,” said Mr. Kahler, the financial adviser in South Dakota. “It’s very clear that the

child owes that money to the estate and it can be adjusted out of his or her share.”

REGISTERING THE LOAN Such official mortgage paperwork can even be registered with the appropriate government authority, so the borrower can legally deduct annual interest payments and the consequences of not repaying are much more official.

To get the loan documentation drawn up, lenders can consult with lawyers willing to do the work for a lump sum, or check out companies like National Family Mortgage, which will help create notes for intra-family loans. For \$599, National Family Mortgage, which focuses on intra-family mortgages specifically, will help families structure a promissory note, including penalty terms, and will also file the loan with the appropriate government authority. For about \$15 a month, the company will also keep the loan an arm’s-length transaction, for instance, by collecting payments from the borrower’s bank account and depositing them in the lender’s account.

Tim Burke, founder of National Family Mortgage, was previously social-lending sales manager for Virgin Money in the United States, which offered similar services for all customers until about a year ago and recently closed its operation in the United States, according to a spokeswoman for Virgin USA. “Virgin Money U.S. is no longer in operation,” she said. “The difficult macro environment in the U.S. made it tough to scale the social-lending business as anticipated.”

RATE CHANGES AND PREPAYING Financial planners say parents can build clauses into loans that ensure neither party is hurt if rates change. For instance, the lender could have the option to raise rates after a certain time period and the borrower could have the option to prepay with no penalty. And they recommend including all children in the discussion when setting up the loan and making sure to reflect the loan in estate plans.

NEAR THE GRANDCHILDREN:

Roey Diefendorf made a mortgage loan to his daughter so that she could buy a home that was close to his.



Such provisions can go a long way toward protecting relationships. Intra-family loans can also benefit families in ways beyond financial returns. For Roey Diefendorf, 58, chief executive of financial planning firm Diefendorf Capital in Locust Valley, N.Y., giving his daughter an intra-family mortgage enabled her to buy a house close to his that she might not otherwise have been able to afford. “The best investment I can have is to have my grandchildren eight minutes away,” he said.