TOPIC: Strategies to Help Your Child Buy a Home

In many major metropolitan areas, where home prices are two-to-three times the national average, buying a home remains a distant dream for most young adults. For these children in their mid-20's to mid-30's, the thought of putting a down payment on a $700,000 or more starter home can be discouraging if not laughable. Even if one can make the down payment, a half-million dollar or more mortgage can seem daunting, particularly since mortgage interest rates are still volatile. Thus, it is no surprise that more and more young adults are turning to mom and dad for help.

The level of financial support in these high priced areas can range from tens of thousands to hundreds of thousands of dollars. Such a major commitment not only raises numerous questions as to the best way for parents to help, but can also raise a number of financial planning and family dynamic questions. Taking time to understand the various strategies available for helping your child buy a home can help ensure that you do not jeopardize your financial goals or instigate a sibling rivalry.

A financial plan or retirement analysis from a competent financial planner can help identify whether you have sufficient assets to help your child, the level of support you might be able to provide and perhaps which assets you should tap first. If your child expects more than you can comfortably afford, sharing this analysis with him or her may ease tensions. You may even wish to have your child participate in discussions with your planner.

Take for example, Fred and Judith Heuser, who were approached by their son about helping him buy his first home in downtown Manhattan where prices for a small condo are sky high. "We knew we wanted to help him, but we quickly realized that there were a lot of things to think about," said Fred. Not only is Fred planning to retire later in the year, but it is important for the Heusers to treat all of their children equitably. "It is important for us to find a way to help our son, have enough income in retirement and still have the ability to help our other children someday."

It is important that parents like the Heusers think carefully about the strategies available. While there are numerous ways you can assist, each strategy can have major estate, tax and family dynamic implications. Here are several different strategies you might consider:

Co-Signing a Loan

If your child cannot qualify for a large enough loan, one option is to co-sign his or her loan application. While this is still an acceptable practice with lenders, it is not always a good idea. All parties to the loan are liable for the full indebtedness. Thus, if your child can't pay, you will be responsible for the debt. Also, your child's debt can impact your ability to partake in a future mortgage transaction or refinance. If, for example, you were to apply for a loan, your child's debt payments would be included in your debt-to-income ratio. Thus, your ratio could be high and some lenders may reject your application as a result. In some cases, this can be overcome by showing evidence that your child is making the mortgage payments.

Patty Hensley, a Mortgage Consultant in Los Altos, California, where the median home price is $1,700,000, occasionally sees parents co-sign a loan with their child to help buy a first home. "Co-signing on a loan can work out just fine if there are very responsible parents and children involved," she says. "However, what many families fail to realize is that some lenders will blend parent's and children's debt-to-income ratios. As a result, your children may not get the best mortgage rates available," she added. Seeking lenders that use only the child's debt-to-income ratio will likely result in a better rate.

Gifting the Down Payment

You can give up to $14,000 (in 2015) each year to each child without having to file a gift tax return. Thus, a married couple could give a total of $28,000 to each child or $56,000 to their child and spouse. This can be a great way to help a first time homebuyer who may be able to qualify for a loan but cannot scrape together enough for a down payment. If your child needs more than $56,000, you might consider gifting the annual maximum over two calendar years. For example, you could give a married couple $112,000 by gifting $56,000 in December and $56,000 again in January. Exceeding the gift limits does not necessarily mean taxes will be due. Rather, it may mean using up part of your $5,430,000 lifetime gift exclusion (in 2015, per person). For parents with large estates, this can mean higher estate taxes when you pass away, resulting in a smaller inheritance for your children.

Gifting the down payment has many advantages. From your child's perspective, she owns the home outright which is probably what she prefers. From your perspective, it is a fairly simple and clean way to help. Additionally, if you have a large estate, the gift may reduce your estate tax liability. However, keep in mind that this is truly a gift;

parents typically cannot deduct any mortgage interest or participate in the appreciation of the home.

"Parents planning to use this approach should plan ahead if at all possible," said Hensley. That is because most lenders will have special requirements for children's parents who fund the down payment, including a minimum 20% down (if the parents fund less than 20%, the child typically must come up with at least 5% down), a signed gift letter, and documentation showing the parents assets. For parents who do not want their child to see their assets, this can be a problem. However, it may be possible to avoid these requirements altogether if parents transfer the funds to their child's account several months before they apply for a loan.

Private Loan

If structured properly, a private loan from you to your child can be very attractive. You can set an interest rate for the loan that may be far less than going market rates resulting in lower payments (and lower total interest paid) for your child, and a higher interest rate than you might receive on a bank or money market account. It is very important to set a rate that is at least as high as the minimum rate set by the IRS, called the Applicable Federal Rate (AFR). Otherwise you can be taxed for the imputed interest. The AFR is still usually well below most banks' best mortgage rates. Moreover, the note can be secured by the property, offering additional protection to you.

To benefit your child, you can also elect at your discretion to forgive interest and/or principal payments, an additional way for wealthy parents to reduce their total estate. The same annual gift limits apply when forgiving payments; however, forgiving $14,000 or $28,000 of payments, in many cases, will eliminate your child's annual payments all together (unless it is a very large loan).

Private loans can also be much more flexible than traditional loans. Though banks can be quite strict with the payment terms, you can set longer grace periods and a more favorable payment schedule. So long as the deed is recorded properly with the county, your child is eligible to deduct the mortgage interest. However, keep in mind that the interest you receive from your child is usually taxable to you as income.

From an investment standpoint, the interest payments you receive from a private loan may be higher than the interest payments you might receive from a money market or bank account. However, if you do not need the funds for many years, you

are more likely to earn a higher rate of return in a diversified portfolio of stocks and bonds. Thus, this loan should not be considered an exceptional investment opportunity.

While many people choose to write up their own loan agreement, it can be wise to hire a real estate attorney or go to http://www.CircleLending.com to draw up a formal document. Doing so can ensure that you do not fall into any tax or estate planning traps. Having a formal document also shows your children that you mean business – this may help reduce the chance the loan will default.

Co-Ownership Agreements

Co-ownership agreements, often called equity sharing agreements, are a formal way for you to share ownership of a home with your child. These types of agreements often work as follows:

You provide the down payment while your child assumes a mortgage for the remainder. For all intents and purposes, your child owns the home. He or she deducts the mortgage interest and receives the capital gain exemption of $250,000 for individuals or $500,000 for married couples when the home is sold (so long as the child has lived in the property for at least two of the last five years). However, when the home is sold, you get back your original deposit plus some predetermined share of the profits (which is specified in the agreement). Moreover, you may be able to deduct the ongoing property expenses and depreciation.

Under these types of agreements, the property typically must be sold within a specific time period such as 5 years, or at a specific triggering event (such as refinancing or divorce). Creating a well-drafted agreement is extremely important. Disagreements can often occur over the appropriate sales price for the home, who to choose as a realtor and when to sell the home.

Similar to the private loan, parents can choose to make annual or periodic gifts of their portion of the equity to their kids. For example, parents could gift as much as $56,000 of equity to a married couple and not exceed the annual gift limits. This type of gifting may require an annual appraisal so that parents know how much their gift is worth, adding an additional cost.

The equity sharing agreement can be a nice option for some parents to help their child buy a home, get their original contribution back and possibly participate in the

appreciation of the home. However, an equity sharing agreement is not perfect for everyone. If the home depreciates, you could lose all or a portion of your initial investment. Setting up a shared equity agreement can be quite complex and expensive. You will want to hire an experienced real estate attorney to draft the agreement to minimize future squabbles with your children and to ensure that you both remain eligible for available tax breaks.

Planning Ahead

If your child is still several years away from purchasing a home, you both have time to plan ahead. Encouraging your child to save as much as possible now may minimize how much you may need to help him or her in the future. Having him deposit a portion of his paycheck automatically to a separate account earmarked for savings is a great way to start. Perhaps you might even consider matching his contributions to enhance his savings. (Be sure to consider the gifting limits discussed previously.) If he is still several years away from buying a home, he might want to consider investing in a low-cost, balanced mutual fund that invests in a diversified mix of stocks and bonds. If your child is just a year or two away from buying a home, money market funds and short-term bond funds are a safer way to go. Most children do not understand how much of an impediment poor credit can be to the mortgage application process. Make sure your child understands that he must have a several-year history of few to no late payments, several sources of credit and both revolving (e.g. credit card) and installment debt (e.g. car loan), handled appropriately before discussion of home ownership should even begin.

When helping your child buy a home in today's very expensive housing market, it is extremely important to understand the impact of each strategy on your overall finances as well as the impact on your family dynamics. For Fred and Judith Heuser, it seems the private loan is the most attractive strategy. "We can give our son a more favorable interest rate than he would get at a bank and the payments can supplement our retirement income," said Fred. The Heusers would expect their son to pay back the loan over-time or when he sells the condo. Thus, the Heusers feel more confident that the loan will not be viewed as a gift by their other children.

The numerous tax, estate and other financial planning implications to consider make it very important for parents to seek competent advice from professionals such as a Certified Financial Planner™, accountant, attorney or loan consultant.

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Strategies to Help Your Children Buy a Home: Summary Table

Strategy	Description	Advantages	Disadvantages	Other Considerations
Co-Signing the Loan	Co-signing a loan with your kids may allow them to qualify for a higher loan amount.	• Simple • Inexpensive • Can help your children build a credit history	• Your children's loan will appear on your credit report. • If anything goes wrong, it can impact your credit report • Your credit report will show a higher debt-to-income ratio which may affect your ability to get additional loans.	• May limit your choice of mortgage lenders and the best rates.

Gift of Down Payment	Gifting your children the money to make a down payment on a home.	• Simple • Can reduce your taxable estate • Children own the home outright	• Parents receive nothing in return. • May require extra loan documentation. And thus sharing of personal financial information with your children.	• Can you afford the gift without adversely impacting your own financial goals? • Will the gift create a sibling rivalry?
Private Loan	You act as the bank, loan your kids money for a first or second mortgage.	• Loan can be secured by the property • Kids can deduct mortgage interest if deed is filed with the county • You can forgive interest or principal up to the gift limits • Can set flexible payment terms	• There's a risk your kids will not make the payments • Better long-term investment alternatives may be found elsewhere	• Set an interest rate that is at least as high as the Applicable Federal Rate set by the IRS

Equity Sharing Agreement	You and your child purchase a home together. You may help with the down payment while your kids assume a mortgage. When the home is sold, you receive your initial investment back along with a portion of the profits.	• You can participate in your children's home as an investment	• If the home depreciates, you can lose all or part of your investment • You may not be able to get your money back quickly	• Work with a real estate attorney to create a clear agreement
Planning Ahead	If your kids are a few years away from buying a home, consider matching their savings.	• May reduce your financial burden when the kids are ready to buy	• Your kids may be ready to buy now	• Encourage your kids to get their credit in shape

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