FPA FINANCIAL PLANNING PERSPECTIVES

Adult Children with Nest Eggs Can Create Private Low-Cost Reverse Mortgages for Their Parents

Parents typically don't like to burden their kids with their financial problems. That hesitancy can sometimes lead seniors to choose financial solutions that charge high fees and often don't deliver what they promise.

Reverse mortgages – advertised so frequently on TV and other media have become a major attraction for people over the age of 62 who need to pay medical bills or otherwise have a need for cash. They are perfectly legal transactions under the law – they are called "reverse" mortgages because of the way they work. Instead of the borrower making payments to the lender, the lender releases equity to the borrower in a lump sum or monthly cash payment, or as a line of credit.

But reverse mortgages can be costly solutions to a senior's cash crunch. Closing fees on a reverse mortgage can go as high as 7 percent of a home's value, compared to a typical high of 3 percent for conventional mortgages. If not part of HUD's HECM program, Interest rates can also be higher than conventional market rates on a reverse mortgage. The lender may also require mortgage insurance and monthly servicing fees. If the homeowner doesn't live in the house for long, a reverse mortgage can end up being an extremely expensive short-term loan.

Plus, there is a counseling requirement that adds time to the process.

But if children or other close relatives have the means, they can buy the house outright or essentially create a private reverse mortgage. Either way, the parent gets the benefit of more cash in their pocket and the adult child may receive some attractive tax benefits. A family reverse mortgage will also avoid the limitations on age 62 and older and type of residence that would be imposed by another lender.

Advice is the first step in this process. A financial planner can team with a tax professional to advise children and parents on these options. A promissory note will need to be written to reflect a revolving credit agreement, and depending on state or county requirements, deeds and other paperwork will need to be filed with local authorities. A loan must be properly documented so as not to trigger the gift tax, and must be at a fair market rate (the applicable federal rate or higher) so as not to be considered a gift.

It's a good way to keep an asset in the family. When the owner dies or moves away, the house can be sold, the loan paid off and any leftover equity value can go to the living owner or the designated heirs. Heirs don't even have to sell the house. They can either pay off the reverse mortgage with their own funds or refinance the outstanding loan balance within a stated time period including extensions.

Also, it's smart for parents to buy additional life insurance which can pay estate taxes if necessary.

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It’s particularly important to structure and record the loan legally so it's less likely to be challenged by other family members after the parents die, but that’s why it makes sense for all family members to be brought in at the idea stage. It's also a good idea to do a title search, in case there are any surprise liens on the home.

There is one other possibility – for the adult children to buy their parents’ home outright and allowing them to live in that property. It’s a way to avoid any and all transaction costs and keep one or both parents in the home for as long as they are able, avoiding the whole loan question altogether.

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