

Family Mortgage

experiences of an AAll member

AAll Research Triangle Chapter

June 8, 2024

John C. Williams

Questions for the Audience

- Let's get to know each other a bit
 - Who likes to make money? Anybody?
 - Who likes to save money on taxes?
- If yes, we must be in the right place!

Introduction: Who is John Williams Anyway?

- Just an average guy, though like each one of you, surely a bit better than average
- Not a professional financial advisor or CPA, not a famous composer, and did not sleep at Holiday Inn Express
- But, I do have quite some experience with today's topics, and I'm a longtime AAll (since 2001) and other best experts reader
- I like to share information, and perhaps, provide some new information many of you may not have heard before

Home Ownership and Mortgage Problems to Solve (slide 1)

- Mortgage rates are in the ballpark 7%, near 20-30 year highs
<https://www.bankrate.com/mortgages/mortgage-rates/>
 - Spread between mortgage rates and 10-year treasury bonds have averaged 1.72% between 2005 and 2019.
<https://www.mortgageresearch.com/articles/10-year-treasury-30-year-mortgage-rate-spread/>
 - Spread was a whopping 4.89% in October 2023, making mortgages relatively much more costly.
 - Additional higher mortgage rate premiums up to 2% to nearly 3% *above* the quoted mortgage rate are charged for those without good credit, raising mortgage payments even higher!
<https://singlefamily.fanniemae.com/media/9391/display>

Note: I'm not quite sure how these are used in practice
- PMI (Private mortgage insurance) premium is required on conventional mortgages with less than 20% down payment
- Added up, it can be impossible for some young people without established good credit, lots of cash savings, and/or high incomes to afford a mortgage

Home Ownership and Mortgage Problems to Solve (slide 2):

- Home prices are way up
 - “the national average house price has risen almost **50%** since the start of the pandemic." Fortune.com, per Capital Economics 4/17/2024
<https://fortune.com/2024/04/17/zillow-home-price-forecast-housing-market-mortgage-rates/>
- 20% down payments amounts are large for higher home prices
- Gifting down payment money can have problems for the giver
 - no financial return on gifted money
 - above the \$18k IRS gift tax exclusion for a down payment incurs tax forms
 - home co-owners may immediately own a share of that equity, and could sell the home and walk away with that any time
- Result: difficult for young people or others to purchase their first home

Home Ownership and Mortgage Problems to Solve (slide 3):

- Investor: nominal treasury bond yields have gone up, but...
 - Investors receive only 2.16% "real yield" (above inflation) on a 10-year US Treasury bond as of 5/31/2024
<https://fred.stlouisfed.org/series/T10YIE>
https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_real_yield_curve&field_tdr_date_value_month=202406
 - Uncertain inflation future prospects add inflation risk and interest rate risk to "safe" guaranteed return government bonds
 - Investors may want a higher yield (both nominal and real)

Solution for some or all of the above problems?

A "private mortgage", or "family mortgage" (also called intra-family mortgage) can be a solution for those problems for some

What is a “Private Mortgage”?

- “A private mortgage provides the financing for purchasing a home and comes from an individual or company that isn't a bank or traditional mortgage lender.” Rocket Mortgage
- Where can I get a private mortgage?
 - National Family Mortgage if the lender and a borrower are family (details below)
 - Other options are beyond the scope of this presentation (and my expertise)
 - My real estate attorney said she could make a private mortgage, with support from a CPA
 - Other options may be available

Benefits of a Private Mortgage for Lenders

- Lender or lenders:
 - Can choose the interest rate (above IRS minimums) and get above treasury bond yield rate of return
 - Can help out someone without means to purchase a home
 - Alternative to gifting down payment money with some advantages
 - Provide financial resources to help a family member at the time of their life when it's most impactful

Benefits of a Private Mortgage for Borrowers

- Depending on the lender terms, the borrower may get either or both:
 - Below market mortgage rate, much better for those without strong credit rating
 - Lower or even no down payment
 - Faster, easier closing, with minimal mortgage bank restrictions and requirements
 - Avoid PMI insurance
 - Loan can offer flexibility in the mortgage terms in case of illness or job loss (more below)

Risks or Concerns with a Private Mortgage (slide 1)

- Lender: interest rates and inflation can change, perhaps a lot, after locking in long-term mortgage terms
 - Borrower may have the option to pay off the loan or refinance, essentially making the mortgage comparable to a callable bond
- Interpersonal relationships can sour if things go wrong; setting expectations matters
- Legal protections for both the lender and borrower should be considered
 - Lender needs confidence that the mortgage will work out as planned
 - Process for managing missed payments

Risks or Concerns with a Private Mortgage (slide 2)

- Hassles of payment processing and tax forms (more on this later)
 - Note: FCI Lender Services, Inc. can provide these services, for a fee
- Illiquidity for lender, compared with a treasury bond that can be easily sold prior to maturity
- Lender must be sure that making the loan won't impact their financial well-being
- Lender could end up subsidizing, with a low interest loan, borrowers using the property as a rental (more on this later)

What is a “Family Mortgage“ (Intra-family Loan), and National Family Mortgage (NFM)?

- National Family Mortgage provides a product and fairly turnkey process for intra-family loans
- Per NFM: “The Lender and at least one Borrower must share one of the following relationship dynamics, including adoptive and step relationships”
 - Parent <> Child
 - Grandparent <> Grandchild
 - Sibling <> Sibling
 - Aunt/Uncle <> Nephew/Niece (for Seller Finance transactions only)
- Co-buyer (spouse or domestic partner of family member) does not need to be a family member
- Reminder: this is not a sales pitch, but information about a product that worked very well for our family

How Did I Find It? What Gave Me the Confidence that it is Legit?

- Internet searches, and two of very trusted finance authors;
- Jonathan Clements was a NFM lender, giving me confidence to try it.
 - I've been a big fan and reader of Clements for 3 decades, having read two of his books, which dealt partly with personal finance of home ownership, and I trust his judgement.
<https://humbledollar.com/money-guide/my-story-a-private-mortgage-for-hannah/>
- Michael Kitces, [kitces.com](https://www.kitces.com/blog/mortgage-high-interest-rate-fixed-arm-heloc-intra-family-loan-financial-advisors/) 1/11/2023:
<https://www.kitces.com/blog/mortgage-high-interest-rate-fixed-arm-heloc-intra-family-loan-financial-advisors/>
- My real estate attorney had closed multiple NFM mortgages

National Family Mortgage Provides All Services Needed (slide 1)

- Charges a fee for setting up the mortgage, based on the mortgage amount
- Provide a support representative to work with the closing attorney, lender, and buyer
 - *NOTE: no support is available until the application fee has been paid*
 - In some cases the support person is Timothy Burke, NFM founder and CEO (extremely experienced and very personable and helpful guy!)
- Provide a set of detailed legal contracts applicable for most (not all) states

Setup Fee	\$2100	\$1725	\$1425	\$1075	\$875	\$725
Loan Size	\$1,000,000+	\$500K+ - \$1M	\$300K+ - \$500K	\$200K+ - \$300K	\$100K+ - \$200K	\$1 - \$100K

National Family Mortgage provides all services needed (slide 2)

- NFM partners with a third party loan servicing provider and platform, FCI Lender Services, Inc, (for a monthly fee)
 - Phone and email support
 - Web site and automated system for receiving mortgage payments, and paying the lender, and reports
 - Late payment support is provided, including late fee penalty amount selected by the lender
 - Tax form 1098 for the borrower
 - Tax form 1099-INT for the lender
 - One-Time Account Setup Fee of \$65

The monthly servicing fee for loans up to \$400K is \$20, paid by either the Borrower or Lender.

The monthly servicing fee for loans over \$400K up to \$1M is an additional \$10/month per \$100K.

Examples: \$500K = \$30 | \$600K = \$40 | \$700K = \$50 | \$800K = \$60 | \$900K = \$70 | \$1M = \$80

Loans over \$1M, add \$20/month, per million. Examples: \$1.5M = \$100 | \$2.5M = \$120 | \$3.5M = \$140

How the NFM Family Mortgage Works

- Lenders and borrowers: read the detailed NFM docs
 - <https://www.nationalfamilymortgage.com/>
 - <https://www.nationalfamilymortgage.com/download-guide/>
 - Confirm they meet the requirements (family, eligible states, etc.)
- NFM, lender, and buyer, work with the real estate closing attorney, and CPA if necessary
- When all is ready, pay the final NFM fee, starting the process
 - NFM support is now available
 - Closing must occur within the 2-3 week time window (not sure if exceptions allowed)

NFM Family Mortgage vs Alternative Private Mortgage

- NFM highly structured
 - Copious legal documents are provided
 - Turn-key paperwork is fairly easy (but lots to read and review)
 - Payment and tax form processing (details above)
 - IRS should be very familiar with NFM, so no surprises are expected
- Alternative private mortgage could save on up-front fees, especially if one doesn't want the payment processing services
 - I have no experience here, so this is beyond the scope of this presentation

How to Structure the Deal, Options Available

- Note: “lender” is used for one or more lenders (spouses), and “borrower” can be one or more borrowers (at least one of which is a family member)
- Lender in general can set or negotiate the terms, but borrower must agree
- Lender and borrower agree on the type of loan, NFM terms:
 - “Win-Win Mortgage”[®] : Amortized Template (Fixed payment of Principal & Interest) or Amortized Template with Balloon”
 - “Gift Mortgage”[®] : Interest-Only Template”
 - More on this below

How to Structure the Deal, Options Available (slide 2)

- Lender and borrower agree on the mortgage amount
 - Family mortgage can be the only mortgage, or a second mortgage on conjunction with other mortgages/loans
 - Duration of the mortgage is negotiable (number of months/years)
- Lender may set the interest rate, and borrower must agree
 - Mortgage rate can be no less than the *IRS Applicable Federal Rate (AFR)*
 - For example, 4.79% lower IRS AFR limit for June 2024
<https://www.irs.gov/applicable-federal-rates>
 - IRS AFR rates rises and fall monthly with long-term treasury bond yields
 - *Important: closing target date must be coordinated with the monthly IRS AFR!*

How to Structure the Deal, Options Available (slide 3)

- Lender decides on the down payment amount, to be agreed with the buyer
 - No down payment is required!
 - Pros and cons:
 - Down payment means borrowers have “skin in the game”
 - lowers mortgage amount and monthly payment
 - Low or no down payment
 - Works for borrowers who don't have cash, with little or no up front gifting needed
 - Allows the borrowers to use their cash for home repairs and upgrades, very useful on an older home
 - With multiple borrowers, low initial home equity makes it easier to buy out another (non family) borrower who wants out of the deal (divorce, break-ups, etc.)

How to Structure the Deal, Options Available (slide 4)

- Lender has control over many details, whether title insurance (recommended), survey, etc. are desired
 - Can simplify closing, avoiding multiple dependencies and time pressure, and traditional mortgage lender requirements and bureaucracy
 - Borrower can have an inspection (recommended)
- Lender and buyer agree on the loan amount for the traditional amortized mortgage
 - Option 1: the entire home purchase price can be borrowed, if no down payment
 - Option 2: purchase price equals down payment plus mortgage amount

Interest-only “Gift” (Gift is Optional) Mortgage (slide 1)

- Borrower's monthly payment is interest only
 - *At the end of the term, for example, 30 years, 100% of the original loan amount is owed!*
 - Borrower paying into principal is allowed (and recommended, see below)
- Why do the interest only mortgage?
 - Borrower monthly payment is much lower than for an amortized mortgage
 - This works well when the buyer may not stay long in the home, but wants a lower payment
 - Example use case: college home for a student, which presumably can be sold after college, hopefully realizing some home price appreciation

Interest-only “Gift” (Gift is Optional) Mortgage (slide 2)

- Why do the interest only mortgage? (cont)
 - The interest only loan can be augmented by cash gifts given to the buyer
 - Gifts under the IRS gift tax exclusion amount are fairly simple
 - \$18,000 for 2024, per giver, per receiver
 - Further details are beyond the scope of this presentation, including spousal combined gifts above \$18k, etc.
<https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2024>
- **CAVEAT:** The IRS frowns on schemes to avoid gift tax, such as a mortgage used to disguise gifts
 - Best practice: the cash gift is best handled separately from the mortgage, to avoid the appearance using the mortgage to circumvent IRS gift tax rules
 - None of the mortgage contracts specify gifting
 - NFM does many “Gift Mortgages”, ethically and legally, so no IRS issues are expected
 - Consult your CPA or tax advisor

Interest-only Mortgage, with Gifting, an Example (slide 1)

- Best illustrated with spreadsheet examples, but here's the description
- Borrower pays a year of mortgage payments to the lender
- Borrower's parent (for example, or anyone) gifts money to the borrower. If below the IRS gift tax exclusion limit of \$18,000 (2024) no gift tax forms are necessary
- Borrower chooses to make an extra principal payment on the mortgage (coincidence!), which is a Great Idea
- The following mortgage interest payment drops a bit, as the mortgage balance is lower

Interest-only Mortgage, with Gifting, an Example (slide 2)

- Best practice recommendation: borrower pays the same payment amount as before, now with a lower required interest amount, plus a small amount of extra principal
- Voila! The house can be paid off per mortgage term, or earlier! Depending on the extra principal amounts, the borrower can own the house free and clear in less than the mortgage term
- This fulfills multiple goals:
 - Giver gradually transfers cash wealth to the receiver without filing gift tax forms, as the receiver manages the loan and home ownership responsibly
 - Gifts can be spread out over time, rather than a large up front gift
 - Creates incentive for the borrower to act responsibly, to ensure getting future gifts!
 - May create incentives to not sell the home or refinance the loan
 - Borrower gets a very low monthly payment!
 - Lender may consider the total net cash flow for mortgage payments received, and gifts given
 - An net effective return can be calculated

Loan Payoffs Prior to Maturity

- Is a refinance among original parties possible?
 - Yes, if all parties agree. There may be some fees (beyond the scope of this presentation)
- Can the borrower payoff the loan, or refinance with another lender?
 - Yes

What are the Risks? What Could Possibly Go Wrong? (slide 1)

- Trust among family members is important, and the borrower must act responsibly
 - Give serious thought to whether this is for you
 - Can the lender come up with the mortgage cash without hardship?
 - Can the borrower responsibly make payments and manage the property?
- Tradeoffs can be considered
 - Is a significant down payment desired so the borrower will feel responsible, and to reduce the mortgage amount?
 - Or is a low or no down payment preferred?
 - Giving the borrower flexibility for expensive needed renovations
 - If the family member borrower has a spouse or partner as a co-owner/borrower, it is easier to buy-out the partner if they want out, keeping the home in the family without forcing a break-up sale

What are the Risks? What Could Possibly Go Wrong? (slide 2)

- What if the borrower gets sick, loses their job, and can't make their payment? What are the options?
 - The lender can allow one or more payments to be skipped, adding the owed interest onto the balance
 - If desired, the terms of the mortgage can be changed, for example, the interest rate
 - there may be some fees involved
 - Worst case: the lender forecloses. There is a process for this
 - *NOTE: NFM says it is very rare for a mortgage to fail.* Typically the family members work things out
 - Can the lender cancel the mortgage because the borrower doesn't cut the grass or paints the house an ugly color?
 - No, sorry, the borrower has legal protections too

What are the Risks? What Could Possibly Go Wrong? (slide 3)

- What if the lender doesn't want their cheap mortgage to subsidize using the family home for a rental?
 - Separate legal contracts can stipulate, for example
 - For multiple borrowers a separate legal contract can specify whether another party can be bought out
 - For example, if the borrower moves out the lender has first right of refusal to require the loan be repaid in full

GEEK OUT: JW's Customized Swiss Army Knife Mortgage Spreadsheet

- Since I couldn't find any spreadsheet to handle all the options, I developed my own custom spreadsheet to manage the payment schedule
- Slices dices chops and purees mortgage data
 - Not seen on TV! Magic ginsu knife not included!

