HMPayson

Alternatives to Conventional Mortgages in an Elevated Interest Rate Environment

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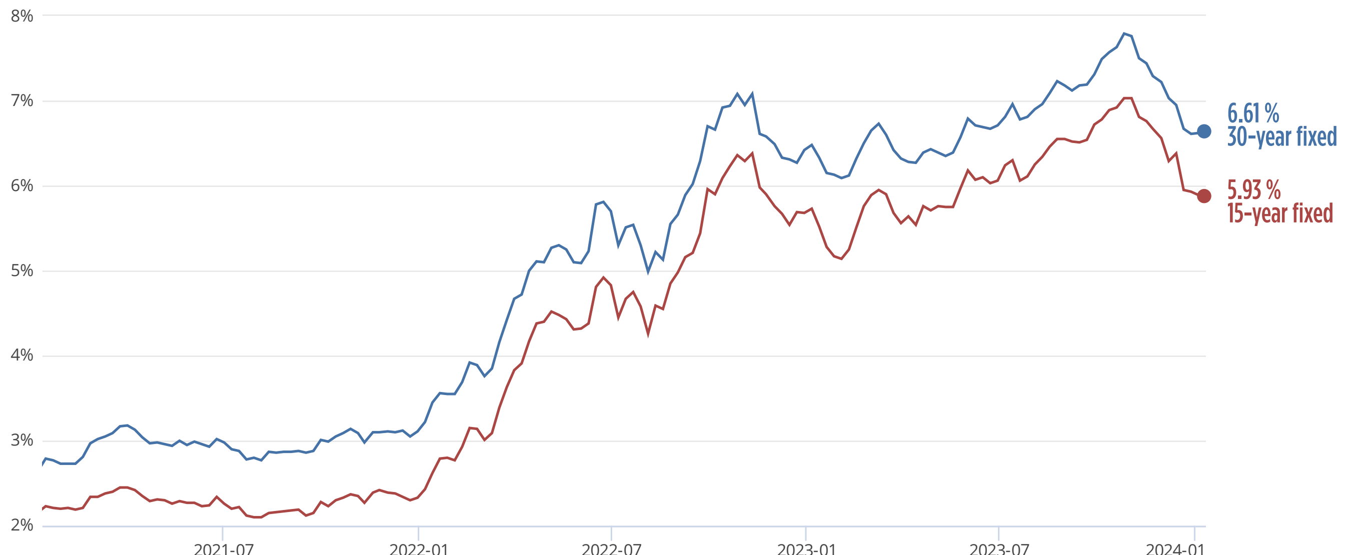
We have all seen the headlines about rising interest rates. Indeed, the Federal Reserve has raised its benchmark rate at an unprecedented pace – 11 times over the past 18 months – in an effort to slow inflation.

And though all signs now point to an end to the Fed's rate-hikes, in this new frontier of 6%-7% mortgage interest rates, the fact remains that the average house hunters have had their buying power cut in half. If that describes you or a family member, you may be wondering if there are any alternatives to conventional financing. Here are a few to consider:

1. Help fund a family member's purchase with an outright gift

Under current Federal law, you may give $18,000 per year, per person, without owing a gift tax or having to report the gift. This amount, which is also inflation-adjusted, is known as the "annual gift exclusion." For example, you could give $18,000 each to your child and your child's spouse each year to help with their mortgage payments or a downpayment.



Current law also allows you to give away $13,610,000 during your lifetime without paying a Federal gift tax. This amount, which is adjusted for inflation each year and is set to be cut in half at the end of 2025, is known as the Federal "lifetime estate and gift tax exclusion." Though you will not owe any tax unless you use your entire lifetime exclusion, you will still need to report any gift *over* the annual gift exclusion by filing a gift tax return (IRS Form 709).

In addition to the obvious benefit of helping family members with their housing needs, such lifetime gifts reduce the donors' taxable estates and thereby reduce their potential exposure to estate tax as well.

2. Set up an intra-family/related party loan

In addition to keeping interest payments within a family and providing the lender with an income stream, intra-family loans may be preferable to conventional mortgages because their minimum interest rates are typically much lower than those offered by lending institutions. For example, as of the date of this note, a 30-year fixed-rate mortgage for a person with an average credit score is just over 6.5%, but the minimum, IRS-set rate for a long-term, intra-family loan is just over 4.5%.

30-YEAR $500,000 MORTGAGE		
Interest rate	4.54%[1]	6.61%
Monthly P&I payment	$2,545	$3,196
Total interest	$416,448	$651,235

To avoid adverse tax consequences for the lender and to ensure the arrangement is recognized by the IRS as a loan (as opposed to a gift in disguise), it is important that the IRS-set minimum interest rates be utilized and that the loan be properly documented. Accordingly, an attorney should always be consulted to be sure the necessary formalities are in place.

Furthermore, if you are the beneficiary of a trust, the trustee may consider making a loan to you from the trust to assist you with a real estate purchase. Because a trustee and a trust beneficiary qualify as "related parties," the same terms described above would apply to a loan from a trust. It is important to note, however, that the terms of a given trust itself may or may not allow for such a loan; and even if your trust does allow for the same, the ultimate decision of whether or not to make the loan will be that of the trustee.

3. Finance the purchase with cash on hand or from a portfolio

If you can pay cash (either on hand, from a portfolio, or some combination thereof), you avoid the monthly cash outflow of a mortgage as well as the added interest expense. You also stand to save on closing costs since you won't have any mortgage origination fees or other lender charges.

Using cash can also speed up the buying process (for example, an appraisal is not required), and present fewer opportunities for something to go wrong. Accordingly, in a competitive housing market, a buyer paying cash may be more attractive to a seller than a buyer who is financing.

Considerations:

Capital gains (raising cash)

If you don't have enough cash on hand for the full purchase price and need to sell stocks to raise cash, you may realize considerable capital gains, increasing your tax liability for the year. Another tax implication of paying all cash is the inability to claim the mortgage interest deduction.

Opportunity cost

Money can be used as an earnings tool; and, if you use it to purchase a home, the opportunity cost is the potential return that you could have earned if you invested that cash instead. Over a long time-horizon, investing cash has the potential to earn you more profits than you would save in interest or closing costs.

Financial flexibility

Using cash reduces the overall total financial assets you will have available for another need (e.g.,

[1] https://www.irs.gov/pub/irs-drop/rr-24-02.pdf

a health event); thereby reducing your financial flexibility. Make sure you are not using all available cash for this one purchase. For example, will you still have enough financial assets to retire when you want?

4. Consider renting rather than buying

Mortgage rates aren't the only things rising; home prices have been going up, too. Higher rates have disincentivized homeowners from moving, leading to fewer houses on the market, and subsequently increasing home prices. Higher rates have also been shrinking the monthly cost-savings associated with buying a home.

Of course, rental markets vary geographically, so you will want to analyze the rental market in your area in particular.

Considerations:

Stability/Hedge against inflation

One major benefit of renting is the fewer periodic costs, like property tax, homeowners' insurance, maintenance and repairs, etc. You're also not typically responsible for expensive unexpected emergencies like a roof replacement or ruptured water heater. This can make renting a predictable expense in the short term; but, beyond the term of your rental agreement, the expense can be subject to unpredictable price increases. Mortgage payments, on the other hand, can stay fixed for decades, providing predictability and a hedge against inflation.

Time frame

If you are moving frequently, renting can be a more flexible option than buying. Renters do not pay closing costs, which can be expensive. If you do not stay in the house long enough, you may not recover the closings costs or down payment.

Equity

When renting, you are not building equity; your monthly payment will never be seen again. With a mortgage, the equity you build each month can act as a cushion down the road.

Taxes

While the Tax Cuts and Jobs Act reduced the benefits of buying a home, there are still some incentives. If you are itemizing your deductions, you can deduct mortgage interest and up to $10,000 of property tax. In general, the higher the marginal tax bracket, the greater the advantage of buying a home.

There's also the benefit involved in selling your primary residence. You can exclude up to $250,000 (single filers) or $500,000 (married filing jointly) of capital gains from the sale of your principal residence as long as you lived in the home for two out of the past five years.

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