CANHR's Guide to Reverse Mortgage Alternatives

Is an Inter-Family Loan Right for You?

Are you a senior homeowner who needs to access cash, but are concerned about the significant risks and costs associated with a reverse mortgage?

If so, you may want to explore other ways to tap into the equity in your home. Consider an Inter-Family Loan with a Secured Promissory Note Agreement.

In a nutshell: An Inter-Family Loan with a Secured Promissory Note Agreement is a private arrangement among family members. It can be a lower-cost, more flexible alternative to a commercial reverse mortgage. The basic elements are:

- The family fronts the homeowner the money they need.
- In exchange for the contributions, the homeowner agrees that the contributors will be paid back, with interest, when the home is sold.
- The terms of the loan and the right to be repaid are spelled-out in a written agreement called the Secured Promissory Note Agreement.
- A second written document called the Contract Lien is needed. The Contract Lien must be recorded (filed) with the County Recorder in the county where the home is located. This tells the world that the contributors have a right to be repaid.

Done properly, families who can support their elders in this manner may create a win-win situation. They can meet the financial needs of the senior while keeping costs down and preserving the family wealth. See the **Appendix B** for a realistic example.

This Guide is designed to help families get started with basic information about crafting an Inter-Family Loan Agreement and Contract Lien. *This Guide is only a starting point.* If you decide to proceed with an Inter-Family Loan Agreement, protect the legal rights of each party to the agreement by consulting with a qualified lawyer and tax professional. These professionals can help draft a contract that reflects your unique situation and protects everyone's interests.

Step One: The Big Picture

There are potentially many benefits for families that choose an Inter-Family Loan. Among others, this method of lending can offer seniors an opportunity to remain at home for as long as feasible, without having to turn to banks or financial institutions for costly loans.

But before proceeding, family members should have a firm understanding of the potential risks, legal and otherwise. These can include complicating relationships with family members, putting one's own financial security at risk, and potential tax implications, all of which should be explored before proceeding with an inter-family loan.

Step Two: The Nuts and Bolts

This guide frequently refers to the **key parties, assets** and **documents** involved in an Inter-Family Loan Agreement. They are:

1. **Owner:** Person who has an ownership interest in property, who is interested in receiving financial contributions from family members or other loved ones.

2. **Contributor**: Person interested in making contributions to an Owner, with the expectation of repayment of the loan, plus interest, from the proceeds of the sale or transfer of the property at a future date.

3. **Home Equity**: This is the Owner's net interest, measured in dollars. It's calculated by subtracting the amount owed on the home from the home's present market value.

4. **Commercial Reverse Mortgage**: Sold by reverse mortgage lenders, these are compounding interest loans. They allow homeowners aged 62 or over to tap into the equity in the home without making monthly payments. Repayment to the lender is due upon leaving the home for a year or upon the death of the borrower, or a failure to keep up with continuing financial obligations.

5. **Secured Promissory Note Agreement**: This is a written contract that contains all the terms and conditions for the Inter-Family Loan.

6. **Contract Lien**: This is a written document that creates the mortgage on the senior's property per the terms of the Inter-Family Loan. It is filed with the County Recorder in the county where the property is located. It preserves the Contributors' rights to be repaid and puts any subsequent third-party creditors on notice of the Contributors' claim against the property.

Step Three: Follow these tips to decide if an inter-family loan is right for your family

1. **Bring everyone in the family together.** In situations where contributions are being made to parents, it is advisable to include all the adult children to discuss what the Secured Promissory Note Agreement is, and to invite everyone to contribute.

2. **Keep things transparent.** It's key to make sure that everyone concerned knows the terms of the agreement. The Inter-Family Loan Agreement with a Secured Promissory Note is not just a financial arrangement; it is an agreement that depends upon – and can help strengthen – family ties.

3. **Select a time and place for your family meeting.** Use the suggested Agenda below.

4. **Prepare to talk to a qualified lawyer and tax professional** after your meeting, if you decide to proceed with an Inter-Family Loan.

Step Four: What Should Be Discussed at the Family Meeting

Start by appointing someone as a note taker. Notes of the meeting are important so that everyone will have a record of what was said and agreed upon.

Some suggested agenda topics:

1. **Explore Alternative Options.** It is important to thoroughly evaluate the Owner's situation, to determine whether a loan is the most appropriate solution. Here are some questions to consider:

   - How much money will the Owner need to meet expenses?

   - Has the Owner considered renting a room in the home, or having someone move in to share expenses? These options can increase opportunities for vital social interaction and potentially increase the Owner's cash flow.

   - Is downsizing an option? Can the home equity be used to purchase a smaller dwelling, rent an apartment, or provide for other housing arrangements?

   - Are there any family members that may be able to chip in and help? If so, then you may consider a Secured Promissory Note Agreement.

2. **Discuss the Benefits of an Inter-Family Loan with a Secured Promissory Note versus a commercially available Reverse Mortgage.** Here are some factors to consider:

   - If a borrower of a reverse mortgage fails to maintain the property, keep up with property taxes, or insurance, the loan will go into default and the home can be foreclosed upon.
     - With a Secured Promissory Note, there is more flexibility and family lenders can choose not to foreclose on the home.
   - Commercial reverse mortgages are expensive and carry ongoing financial obligations that may be overly burdensome to the Owner. Reverse mortgages are compounding interest loans. This means the debt to the lender grows quickly and the Owner will exhaust their existing home equity in a short period of time. Commercial reverse mortgages also come with costly lender fees and closing costs--just to create the loan.
     - By choosing an Inter-Family Loan with a Secured Promissory Note Agreement, family members can help the Owner avoid the loan costs. By reducing costs, they can also help preserve the equity in the family home.
   - When a borrower of a reverse mortgage dies or permanently moves out of the home, the loan becomes due, even if there is a disabled child or other relative living in the home.
     - With a Secured Promissory Note Agreement, family members can choose not to immediately sell the house.
   - Financial benefits to a Secured Promissory Note. A commercial reverse mortgage provides no investment opportunities to family members who are making valuable contributions.
     - Family members who participate in a Secured Promissory Note Agreement can help preserve the family home, have a secured loan that produces interest and may be making the safest retirement investment, ever.
   - If the Owner dies, the family members will have the option and ability to potentially keep the family home.

3. **Discuss the financial role of each Contributor.** Each Contributor's commitments should never be for more than the Contributor can comfortably afford. To maximize the success of this arrangement and to minimize stress on any one Contributor, it's best when there are multiple family members participating. Some families may decide that they want to consider the economic value of a Contributor's in-kind contributions, such as providing caretaking services. **See Family Caregiver Alliance's factsheet on Personal Care Agreements in the Resources section below**. An Inter-Family Loan Agreement can allow for such flexibility.

   - Tracking Contributions. The participants need to track how much they are lending (or the value of an in-kind contribution) each month. A simple ledger or spreadsheet can be developed that records the date and amount of contributions over time, while calculating the amount of interest accruing. **See Sample Contributions spreadsheet in Appendix A.**

- Interest. In setting up a Secured Promissory Note Agreement it is best to consult with a Certified Public Accountant about what interest rate to use. There are legal limits and there may be tax consequences associated with interest rates.

- How much to contribute depends on how much is needed. While everyone can use more money, the Inter-Family Loan secured by the Promissory Note is meant to cover the essentials of living. Find out how much the Owner really needs to keep going. It may only be a matter of a few hundred dollars per month, an amount that can comfortably be handled by the collective group of contributors.

- Distribution when the house is sold or transferred to another. When the house is sold, or transferred to another, those who have contributed to the Owner receive what they loaned, plus interest. After those who have participated in the Secured Promissory Note Agreement are paid off, then the balance of the estate will be split according to the senior's estate plan.

Step Five: Getting Started and Protecting the Contributors' Right to Reimbursement

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You've considered what's involved and your family is ready to get started. Here are next steps:

1. **Meet with an estate planning attorney** who is qualified to advise your family and can draft the Secured Promissory Note Agreement and Contract Lien to meet your family's specific needs.

2. **Add in an "open-end" mortgage clause if you will be making a series of contributions over time.** Most Inter-Family Loan Agreements will contemplate a series of contributions, not just a one-time contribution. In such cases, it will be necessary to add in an "open-end" mortgage clause with a capped amount of contributions. The open-end clause is a provision in the mortgage contract that declares the mortgaged real estate may be used as security for future additional contributions up to the capped amount. All subsequent contributions up to the capped amount represent a claim on the property dating back to the time of the recording the original mortgage. If you expect to make contributions that exceed the capped amount, consult with your attorney first for advice on how to protect your right to repayment on any additional amounts.

3. **Secure the Contributors' right to repayment (perfecting the lien): After the Inter-Family Loan Agreement is written, and the Contract Lien is created, there is an important additional step which must be taken to protect the Contributors' right to**

repayment. The estate planning attorney should have the Contract Lien recorded (filed) with the County Recorder in the county where the Owners' home is located. This is necessary to protect the rights of the Contributors and to alert third-party creditors that the Inter-Family Loan (mortgage) exits and that the Contributors have priority for repayment against the home before subsequently recorded mortgages.

- There are exceptions to lien priority for an Inter-Family Loan which you should discuss with your attorney. For example;

    - **A property tax lien can take priority over a previously recorded Contract Lien.**

    - **If the Owner is on Medi-Cal or may enroll in Medi-Cal in the future,** you should take steps to avoid Medi-Cal Recovery (for individuals who die on or after January 1, 2017, a living trust will allow the Owner to avoid probate, and protect the home from a Medi-Cal Recovery claim.) Consult CANHR's Medi-Cal Recovery Guide or contact CANHR at (800) 474-1116 for more information.

4. **To protect their interest, any party to an Inter-Family Loan Agreement should additionally consider:**

- The value and condition of the real property that is the subject of the loan. Have the property appraised to determine value and inspected by a contractor to understand any maintenance issues that may need attention to preserve the value of the property.

- Lien position. California law gives lien repayment priority to those who are first in line with recorded liens. As noted above, some liens, such as a tax lien, are given priority regardless of when they are recorded. Consult with your attorney to understand what liens may be on the property and whether it is advisable to pay them off before entering into the Inter-Family Loan.

- Possible Internal Revenue Service Gift Tax Implications. If the interest rate on the Inter-Family Loan is too low, this could trigger gift tax liability. Contributors should talk with their attorney and tax professional about how to best structure the Inter-Family Loan Agreement contributions and expected interest rates for repayment.

5. **When changes to the original Inter-Family Loan terms are needed.** The Contributors and Owner may want to amend the original agreement at a future point to include new contributors or new terms. All parties to the original agreement should agree to any changes and put them in writing. Any changes should involve the same formality as the original agreement and include the advice and counsel of a qualified attorney and tax professional.

APPENDIX A:
Resources

1. California State Bar Lawyer Referral Service:
   www.calbar.ca.gov/Public/LawyerReferralServicesLRS.aspx

2. California Certified Public Accountants (CPA):
   www.dca.ca.gov/cba/consumers/select-a-cpa.shtml

3. Contribution Spreadsheet:
   www.canhr.org/abuse_fs/contribution-spreadsheet.xlsx

4. Family Caregiver Alliance Factsheet on Personal Care Agreements:
   www.caregiver.org/personal-care-agreements

5. Long-Term Care Information:
   www.canhr.org

6. Medi-Cal Recovery Claims Information:
   www.canhr.org/medcal/medcal_recoveryinfo.htm

7. Sample Inter-Family Loan Secured Promissory Note Agreement:
   www.canhr.org/factsheets/abuse_fs/sample_promissory_note.pdf

CANHR does not endorse any individual on the referral list.

APPENDIX B:
A Realistic Scenario

Four adult children contribute to their mother, Mary. Mary's house is paid off with a current market value of $400,000. Mary expects to leave each of her four children an equal share of her estate, which consists of her home. If Mary were to die today, each of the children would get a ¼ share of the equity in the house. But right now, Mary doesn't have enough income to make ends meet. How can her children help close this gap?

- Every month, Mary's expenses exceed her income by six hundred dollars ($600). If each of her children were to contribute $150 per month, Mary's costs would be covered. However, not every child has the same amount of extra cash to lend.

- One child has a job paying $75,000 per year; one has job that pays $50,000; one makes $35,000 per year, and one child is unemployed.

- The 5% investment solution. Financial advisors would say that if possible, an individual should set aside at least five percent (5%) each month out of every paycheck. If the children who made $75,000, $50,000, and $35,000 respectively, were each to put up five percent (5%) of their income, that would more than cover Mary's $600 shortfall even though each child contributes a different amount. Here's how that would work, in approximate figures:

    5% of $75,000 is $313 per month

    5% of $50,000 is $208 per month

    5% of $35,000 is $146 per month

In this example, with each child contributing five percent of their monthly paychecks to cover their mother's expenses, the children are able to make a collective contribution of $667.00

- Flexibility. In the above example, three children can make monthly contributions that exceed their mother's need for $600. This means that in some months not every child has to put in a maximum amount. What is important is that the total of contributions equal the mother's needs.

APPENDIX C

Potential Benefits of an Inter-Family Loan vs. a Commercial Reverse Mortgage	Other Important Considerations
• Involves family members who make contributions instead of a company that sells reverse mortgages. • Will be less expensive to set up and maintain. • Allows for more flexible terms than a commercial reverse mortgage. • Keeps costs down and preserves the home's equity. • Requires sound legal and tax planning advice which can help families make an informed choice to assess their best options.	• Encourages multiple family members who can contribute. • Encourages family members to work together. • Sets up safeguards to prevent Contributors from lending beyond their means. • Encourages Contributors to seek guidance from qualified professionals to avoid triggering any negative tax consequences.