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January 17, 2023 – Wealth Planning Commentary

Strategies to buy a home in a higher interest rate environment

Many who are considering purchasing a property are realizing that rising interest rates and market prices have caused mortgage payments to increase significantly over the last year. To make a down payment, buyers must save more, withdraw more from taxable accounts, or draw on pledged asset lines. Higher monthly payments negatively impact the buyer's cash flow and may result in reduced asset accumulation over the long-term.

Even so, our view is that the current rates and prices should not dissuade one from purchasing that 'perfect' home. The caveat is that the purchase avoids jeopardizing the success of the home-buyers long-term financial security. Rates may come down at some point in the next few years and may present an opportunity to refinance. If rates increase, then it was good to lock in the lower rate today. Keep in mind that today's approximately 6.5% 30-year mortgage rate is 1.5% lower than the long-term average of 8%.

Intra-family loans are an excellent strategy to finance home purchases, if available. Family members may lend money to other family members at favorable rates. Interest rates for these loans are based on the Applicable Federal Rate (AFR) and are typically lower than commercial rates. December's 30-year fixed mortgage rate was 6.39%, and long-term AFR was about 2% lower at 4.34%.

Intra-family loans are between family members but require a formal process and documentation. The IRS will honor AFR rates if the following conditions are met: the existence of a signed promissory note, the lender must have collateral, a fixed maturity date is set, the intent of payment, and records of transactions between lender and borrower. These loans may attract scrutiny from the IRS. Ask your accountant to keep comprehensive documentation to help avoid any potential issues. Using a middleman, such as National Family Mortgage, is a good idea to ensure the loan is handled carefully and avoid inadvertent gift tax. Intra-family loans may be refinanced, but that may trigger gifting, proceed with caution.

Adjustable-Rate Mortgages (ARM) are a great medium-term solution to lock in a lower rate. In December, the 30-year fixed mortgage rate was 6.39%, and the 5/1 ARM was 5.9%, about half a percent lower. The initial low-interest rate on an ARM may be fixed anywhere between three to ten years. A '5/1 ARM' will have fixed rates for the first five years, and then the rates are variable and typically higher than fixed rates. ARMs may be refinanced at any time, and most borrowers perform the transaction when ARM rates are lower or when the fixed rate portion of the ARM is scheduled to expire.

Higher interest rates mean that it is not an ideal time to draw down on home equity lines of credit (HELOC) or consider a reverse mortgage, even though market conditions may have significantly increased home values. Home prices are still said to be holding their ground, and there is a high likelihood that the value of the property has appreciated since its purchase. It might be a good time for some individuals to consider downsizing their property and take some equity off the table.

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