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How to Fund a Down Payment

Employ these strategies to obtain that all-important sum

By Tobie Stanger
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More than one-third of respondents in Consumer Reports' national homeownership survey of more than 1,500 millennials said they didn't own a home because they hadn't saved enough for a down payment. They might be surprised to learn that since late 2014, Fannie Mae and Freddie Mac, the quasi-government entities that underwrite at least half of the country's mortgages, have offered mortgages that require just 3 percent down, a reduction from the 5 percent down required for standard mortgages.

But a small down payment has its drawbacks. Until your home equity reaches 20 percent, you'll need to pay mortgage insurance—an annual cost of usually 0.5 to 1 percent of the loan's value, paid monthly—which compensates the lender if you default. (FHA mortgages require mortgage insurance for the duration of the loan.) You'll also face larger monthly payments. And a large down payment has an edge with sellers because they perceive the mortgage as more likely to be approved.

An obvious tactic is to generate more income with a second job or part-time business and dedicate as much as possible to your down payment. But reaching your loan goal may require additional strategies and sources.

• **Find a no-interest loan.** States, counties, and even municipalities offer low- or no-interest loans—essentially second mortgages—that can be used toward down payment and closing costs. The assistance could even be a grant that doesn't need repayment. Those programs are often a municipal strategy to make sure educators, first responders, health care workers, and those in other valued professions can afford to live in the community, or to encourage purchases in certain geographic areas. Search to see whether you're eligible at downpaymentresource.com, which aggregates from about 2,400 programs nationwide. Rob Chrane, the site's founder, says the loan amount most frequently found on the site is $10,000; each program has its own eligibility terms. In early January we looked for programs in Union County, N.J., not earmarked for specific professions. We found six for a household of four with an annual income of $100,000; at $101,000 there were just two eligible programs.

• **Automate savings.** Have your tax refund direct-deposited to a down payment fund. Direct deposit a portion of your paycheck, too. Use the Digit app, which analyzes income and spending patterns, and periodically sweeps a few dollars you won't miss into an FDIC-insured online Digit account. You can later move the money to an online or virtual bank to earn more interest.

• **Tap family members.** Those capable of such generosity can give up to $14,000 to an unlimited number of people each year and still face no federal gift tax. For example, parents could each give a son and daughter-in-law $14,000; that's $28,000 per person, or $56,000 total. Parents or grandparents with means also could withdraw $10,000 penalty-free from their IRAs to fund qualified costs related to a first home, including closing, finance, and settlement costs; each member of a couple could receive $10,000. But unless the giver is close to retirement and won't need the money, it's better to leave it invested and growing.

• **Crowdfund.** Of the more than 600 appeals for help with down payments we viewed recently on the free crowdfunding site GoFundMe, the most remunerative requests involved a family facing hard times or a catastrophe. But one relatively successful appeal that didn't focus on tragedy was "Need closing $$ for baby's new home," by a mother in Euclid, Ohio. She posted an engaging selfie in front of her modest dream house and wrote about working two jobs, bargaining with the seller, and exhausting her savings. In four months she raised $510 of her $1,100 goal.

• **Withdraw Roth savings.** If you must use retirement savings, withdraw funds first from a Roth IRA. As with gifts from relatives, first-time home buyers can withdraw up to $10,000 from their own Roth or traditional IRAs without penalty for qualified home-buying costs. But such withdrawals from a Roth that has been in place for five years or longer aren't subject to federal income tax.

• **Borrow from your 401(k).** The IRS says certain 401(k) plans can let participants borrow $50,000 or up to half of savings—whichever is smaller—from the vested portion of their accounts. Home buyers can stretch out that loan to as long as 30 years. Pluses: A 401(k) loan doesn't count toward your debt-to-income ratio because it's secured, usually by your account balance, and you pay the interest to yourself, not a bank. Your 401(k) loan won't be reflected on credit reports.

But the gambit has risks, and costs. Repayment must be made with post-tax dollars. At retirement, you'll pay ordinary income tax on distributions, including what you borrowed and repaid. So you'll be taxed twice on the borrowed sum.

Remember that your borrowings won't grow along with the rest of your 401(k). The long-term cost of not having that money invested—known as the opportunity cost—can be significant. For instance, a 35-year-old paying back $30,000 over 15 years would have $70,538 less in his 401(k) at age 70 than if he hadn't borrowed, estimates Michael Chadwick, a financial adviser in Unionville and Torrington, Conn., and Manlius, N.Y. He calculated the historical return of a balanced portfolio of 8 percent, at a 15 percent marginal income tax bracket and a 4 percent interest rate on the loan paid back to oneself.

Should Parents Play Mortgage Banker?

If you have the resources to help a son or daughter buy a home, you might consider lending all or part of a mortgage, or the down payment. Intrafamily loans, as they are called, can benefit both sides financially. If you loaned your child money at, say, 3.5 percent, you'd get a return exceeding the 2.25 percent that a diversified bond portfolio currently yields. Your child would get an interest rate lower than the national average of around 4 percent that banks are now offering for 30-year fixed mortgages.

What's more, such loans usually don't have loan-origination fees, points, mortgage insurance, or other, onerous lender costs. And families can arrange for flexible repayment schedules. Just be aware that the deals must be crafted carefully to avoid IRS scrutiny—and family acrimony.

Mind the Taxes: You'll need to ensure that any loan higher than $14,000 is not construed as a gift, subject to the hefty federal gift tax of up to 40 percent. So set the interest rate at least as high as the IRS monthly Applicable Federal Rate (AFR), currently about 2.5 percent for long-term loans. You can find the AFR easily at the National Family Mortgage, a service that helps create intrafamily loans. Second, have an attorney draft a detailed promissory note and record it properly under state and local laws. That way, your child can claim a mortgage interest deduction. You will have to claim the interest portion of the mortgage payments paid to you as income on your tax returns.

Avoid a Family Flare-Up: Before you draft the paperwork, make sure all interested parties communicate fully, stresses ReKeithen Miller, a Certified Financial Planner at Palisades Hudson Financial Group in Atlanta. A common scenario he has seen is when a parent discusses the loan terms with an offspring yet fails to include his or her spouse in the conversation. Then when the informed parent dies, the adult child insists that the deceased parent forgave the loan. “Now mom has to decide if her child is telling the truth,” Miller warns. He suggests using caution with such arrangements. “I generally advise clients that they probably shouldn’t loan any amount of money they can’t stand to lose,” he says.