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Elder Law Guys: Lending parents money to stay in their homes has pitfalls

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A little over three years ago, we touched on the subject of intra-family loans and the pitfalls of not understanding how seniors can be penalized for legitimate loans to their adult children when facing scrutiny for Medicaid coverage of long-term care costs.

The lesson? Any time large sums of money are changing hands between generations, the transaction should be well documented to protect the parties in the future.

A new twist on this issue involves the increasing number of adult children lending money to their parents so the parents can maintain the lifestyle they are accustomed to while "aging in place/at home." That place is usually the parents' residence that is full of equity (and an attic full of interesting relics).

For seniors with limited liquid assets, the traditional method for financing their lifestyle was to obtain a reverse mortgage from a bank or other commercial lender.

While the appropriateness of a reverse mortgage for each person is beyond the scope of this article, for purposes of our discussion the senior has made the decision to tap the home's equity. The reverse mortgage basically allows the homeowner to use the home's intrinsic value to obtain cash.

Some day in the future the home will be sold and the lender repaid from the sale proceeds.

Some families have an adult child who is financially well off enough to act as the bank in this transaction and — usually on a handshake — is willing to loan Mom or Dad a significant amount of money with the expectation that, in the future, the child will receive the house in return for the loan or be repaid when the home is sold.

The problem is that no one can control when the parent needs long term care.

For example, let's say wealthy son loans $100,000 to parent over several years. Then, one day parent ends up in a nursing home or using a home and community-based service to receive care in the parent's home.

For individuals receiving such nursing services (which are paid for through the Pennsylvania Department of Human Services), a "tab" of sorts is started in Harrisburg that will come due at death.

Let's say the nursing costs were $100,000 for the parent and it's now time for the state to collect.

Since the home is the parent's only asset, the Department of Human Services gets paid its full $100,000 debt before the wealthy son is repaid a penny.

Why? The son has copies of dozens of checks for his parent's benefit. Outrageous? No, just legal enough.

In this scenario, the son is simply an unsecured creditor. When the parent dies the state is a higher-class creditor.

What could they have done differently?

Parent and son could have entered into a simple loan documentation agreement whereby parent signs a note for the loan tied to a mortgage which secures the debt to the parent's home. Result under this improved arrangement: son gets $100,000, state gets whatever is left after that.

Let's face it, the commercial reverse mortgage industry deals with millions of dollars of loans to seniors. Those lenders are not going to take the risk of having the home equity compromised to repay the state Medicaid agency, and neither should the family member who takes a much greater financial risk.

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