Bank of Mum and Dad pitfalls

inance

he rise in lending from arents to their children aises problems of both eneral financial stability nd tax avoidance.

Alex Erskine

The rise in borrowing from parents or family for real estate purchases, colloquially called the "Bank of Mum and Dad" (henceforth "B-MaD"), is being welcomed for providing some first-home buyers (FHBs) with buying power, with some researchers seeing B-MaD as the 11th or even the fifth-largest lender to FHBs.

Hard data on the phenomenon is scarce. The Reserve Bank of Australia's John Simon and Tahlee Stone confirm "a rising though still small share of FHBs are receiving financial assistance from family and friends" to 14 per cent in 2011-2014, up from less than 7 per cent in the 1970s. But it has almost certainly risen since then, perhaps driven by guilt: parents finding they have benefited from the house price inflation that may be locking their children out of the housing market.

However, such lending raises several problems. At the margin, borrowing from parents disintermediates the financial system and weakens the efficacy of monetary policy. More importantly, it loads risk onto individuals who may prove less capable of bearing it and – crucially – increases the risk of tax evasion. It also exacerbates inequality.

So far only the broader impact, of widening the gap between the "haves" and "have-nots", has received much scrutiny. Anecdotally issues also are emerging when parents die: wills increasingly are being contested to ensure equity among siblings. But the other undesirable effects are no less important.

Cutting back the savings usually channelled through regulated "responsible" lenders will weaken the economy-wide supply of funds, and shifts more financing outside the public safety net. Parental loans are unlikely to be priced at market-related interest rates, and their lending will not face the policy-driven tightening in restrictions on lending for housing.

It is always true that some "B-MaD branches" have money to spare, and will not suffer much when some evaporates once housing prices turn down. But others may become substantially under-provisioned for their needs for retirement income. The age pension will likely have to be drawn on more than anticipated.

But the more immediate undesirable effect is on the tax base and on tax compliance. Everyone knows that all sources of income, including interest income, have to be declared annually for tax purposes. But the temptation to "forget" to declare undocumented, inside-the-family, interest receipts must be acute.

The children are likely not to be paying a full arms-length interest rate on their borrowings from their after-tax income, and the parents are likely not to be paying full tax on the interest that they are, or should be, receiving from their children.

In Britain the tax concerns have been well aired, because loans or gifts from parents have to be taken into account in calculating inheritance tax obligations.

Unlike Britain, Australia does not have an inheritance tax. In time Australia will need an inheritance tax to properly protect the tax base. However, the politics of introducing such a tax in Australia is beyond any of our political parties.

But not all is lost. We do have a means-tested social welfare system that includes "deeming" interest income on loans and rules restricting access to welfare benefits for those giving larger gifts over time. This system can be tinkered with to useful effect.

Wills ... are being contested to ensure equity among siblings.

For instance, Centrelink uses deeming to work out income from financial assets. It assumes these assets earn a set rate of income, no matter what they really earn. The current deeming rate is 1.75 per cent for assets below a modest threshold and 3.25 per cent above that threshold.

Parliament should consider instructing the Australian Taxation Office to also apply deeming, at least to interest on loans from the Bank of Mum and Dad. It could suggest the ATO use the standard variable mortgage interest rate as the deeming rate. That is now a low 5.2 per cent (the lowest since 1965). An alternative would be the discounted variable rate, at 4.45 per cent.

Such ATO action would likely lead to conversion of some loans to gifts, exposing the rather soft edges of our personal income tax base. But it might also constrain the willingness of some parents to fund their children's housing purchases, saving them from future strife and taking ill-advised fuel out of the market. Warnings from the authorities on rising house prices and debt risk otherwise will likely fall on deaf ears.

Alex Erskine is managing director and founder of Erskinomics Consulting.