



# Recovering a Lost Deduction

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**Although the conventional approach for passing a borrower's home equity to heirs generally results in the loss of the deduction for reverse mortgage loan interest, the deduction may be used if it is connected with income, such as when the borrower has a 401(k) account or rollover IRA.**

This article examines the conditions, requirements and limitations on deductions of the interest accrued on reverse mortgage loans.<sup>1</sup> Close to one million reverse mortgage loans are currently outstanding. As the 75 million members of the Baby Boomer generation march into retirement over the coming 15 years, the number of reverse mortgage loans will likely increase significantly.<sup>2</sup>

Reverse mortgage loans accrue interest, generally over long periods. Because essentially all of the borrowers are cash method taxpayers, that interest is not deductible until it is actually paid. Payment is usually, but not always, made when the home securing the loan is sold. Other conditions and requirements limit the obligor's ability to claim the deduction.

The deduction is lost if the home is sold by a person (or entity) who (or that) does not have sufficient income to

be offset by the deduction. As described below in this article, the conventional approach for passing the borrower's home equity to the heir(s) will generally result in the loss of the deduction. The authors suggest to estate planners and probate attorneys a simple alternate approach, connecting the deduction with income, to take advantage of the deduction. This approach can be used most often, but not exclusively, when the borrower has a defined contribution retirement account, such as a 401(k) account or a rollover IRA.

Quantitative estimates of the relevant interest amounts and retirement account values, derived from Monte Carlo simulations, are provided in illustrative examples.

## **OVERVIEW**

Most people, including tax practitioners, have only a limited understanding

of reverse mortgages. Therefore, a summary of the salient features of reverse mortgages is provided in the Appendix at the end of the article. For purposes of this article, however, a reverse mortgage is simply a loan secured by the borrower's principal residence, the most relevant feature of which is that repayment is not required until the borrower permanently leaves the residence.<sup>3</sup> A reverse mortgage loan can be used in many different ways: For example, it can be used like a conventional purchase money mortgage loan, to pay a portion of the purchase price of a new residence of the borrower; it can also be used like a conventional HELOC (Home Equity Line of Credit), drawn upon at the times, and in the amounts, that the borrower chooses, to be used for any purpose.

This article is focused on the deferred repayment and the interest that accrues as a result of that deferral. As long as the repayment is deferred, the interest accrues and compounds. As noted above, most individuals are cash method taxpayers, so the interest that accrues is not deductible until it is actually paid. The concerns in this article are about how much of that interest is deductible and by whom.

The particular use of the loan proceeds determines the characterization of the indebtedness. If the proceeds are used for acquisition or substantial improvement of the residence, or to refinance an earlier loan that was used for that purpose,<sup>4</sup> the indebtedness is characterized for tax purposes as "acquisition indebtedness" under Section 163(h)(3)(B)(i). If, on the other hand, the loan is used for any other purpose, it is characterized as "home equity indebtedness" under Section 163(h)(3)(C)(i). The characterization, in turn, determines the conditions, requirements and limitations on the de-

ductibility of the accrued interest when it is actually paid.

The next section sets out the statutory and regulatory framework that establishes the conditions, requirements, and limitations on the deductibility of the accrued interest. After that, a couple of illustrative examples of how reverse mortgages can be used with substantial benefit as part of retirement income planning are provided. Next, tax analysis is applied to the deduction of the interest determined in those examples.

### THE PROVISIONS OF THE CODE AND REGULATIONS GOVERNING THE INTEREST DEDUCTION

Section 163(h) has a rather convoluted structure, which provides that, in the case of an individual taxpayer, no deduction is allowed for "personal interest," and then specifies that personal interest is any interest allowable as a deduction *other than* items listed under subsection (h)(2). The items listed under subsection (h)(2) include "qualified residence interest." "Qualified residence interest," in turn, is defined in subsection (h)(3) to be "any interest which is paid or accrued" on acquisition indebtedness or home equity indebtedness. A loan that refinances acquisition indebtedness is also treated as acquisition indebtedness.

#### Acquisition Indebtedness

Section 163(h)(3)(B)(i) defines "acquisition indebtedness" as "any indebtedness which—(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and (II) is secured by such residence."

**Application in the Reverse Mortgage Context.** As pointed out in the Appen-

dix, reverse mortgages can be obtained only by borrowers who are 62 years of age or older. A reverse mortgage that involves acquisition indebtedness is, in most cases, incurred when a borrower uses the reverse mortgage for one of the following purposes: (1) to acquire a home<sup>5</sup> that constitutes "downsizing" from a larger home, after children have grown up and moved out, or that constitutes a move to a more "retirement friendly" location; (2) to substantially remodel a current home to make it safer or more comfortable for residents as they age; or (3) to refinance an earlier mortgage loan taken to acquire, construct, or substantially improve the current home, and thereby eliminate the need to continue making payments on the earlier mortgage loan.

The first of the two examples discussed later in this article will illustrate the use of a reverse mortgage for acquisition of a downsized home for a retiree and the deduction of the interest accrued on such a reverse mortgage.

**Limit on Deductible Interest.** The amount of indebtedness that can be treated as acquisition indebtedness cannot exceed \$1 million.<sup>6</sup> Therefore, the amount of interest on acquisition indebtedness cannot exceed the interest on \$1 million. In the reverse mortgage context, when the interest is generally not paid until many years after the indebtedness is incurred, interest on acquisition indebtedness can grow to a large figure. However, when interest grows *and compounds*, it is important to ask whether *interest on interest* on acquisition indebtedness is treated as interest on acquisition indebtedness. There does not appear to be any authority that answers this question, so the authors read the statute very literally and take the conservative position that the interest accrued on the interest on acquisition indebtedness is home equity indebtedness. This home equity indebtedness itself will not be deductible, but interest on it will be deductible, subject to the limit on home equity indebtedness, which is discussed directly below.<sup>7</sup> As the illustration in footnote 7 shows, this interest amount is trivial

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in comparison with the simple interest on the acquisition indebtedness.

Accordingly, with regard to the interest on acquisition indebtedness, only the *simple* interest will be treated as deductible.

### Home Equity Indebtedness

Section 163(h)(3)(C)(i) defines home equity indebtedness as “any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed—(I) the fair market value of such qualified residence, reduced by (II) the amount of acquisition indebtedness with respect to such residence.”

#### Application in the Reverse Mortgage

**Context.** Clearly, if a reverse mortgage is taken at a time when there is little or none of the purchase money mortgage remaining to be paid, the reverse mortgage debt will not be “acquisition indebtedness”; it will be “home equity

credit line, used in coordination with a securities portfolio, can be a very effective mechanism to stabilize and even enhance the retirement income of retirees whose primary source of income is the securities portfolio. (The portfolio is typically, but not necessarily, held in a 401(k) account, a rollover IRA, or some other defined contribution account).<sup>8</sup> The retirees who can benefit to the greatest extent are the “mass affluent” retirees, described below. Further research is currently being done on the use of reverse mortgage credit lines to stabilize and enhance the retirement income of retirees who have defined contribution accounts but are not in the “mass affluent” category.<sup>9</sup>

The second of the two examples discussed later in this article will illustrate the use of a reverse mortgage credit line to stabilize and enhance retirement income drawn primarily from a securities portfolio and the de-

indebtedness is treated as home equity indebtedness, so that interest on those amounts can accrue and compound each year, until the total home equity indebtedness reaches \$100,000. However, only the *interest* on the home equity indebtedness is deductible.

### The Same Transaction Can Give Rise to Both Types of Indebtedness.

Nothing in Section 163 states that there cannot be deductions for interest on *both* acquisition indebtedness and home equity indebtedness secured by the same property and incurred as parts of the same loan transaction. In fact, Rev. Rul. 2010-25, 2010-44 IRB 571 specifically allows interest deductions for interest both on acquisition indebtedness and on home equity indebtedness, secured by the same property and incurred as parts of the same transaction. Therefore, the total interest that can be deducted (subject to the limitations described herein) is the



**Nothing in Section 163 states that there cannot be deductions for interest on *both* acquisition indebtedness and home equity indebtedness secured by the same property and incurred as parts of the same loan transaction.**

indebtedness.” Most often in this situation the reverse mortgage will be taken in the form of a line of credit, with the proceeds used for the borrower’s personal living expenses. Recent scholarly and academic research has shown that a reverse mortgage

deduction of the interest accrued on such a reverse mortgage.

**Limit on Deductible Interest.** The amount of indebtedness that can be treated as home equity indebtedness is \$100,000.<sup>10</sup> As noted above, the interest on the interest on acquisition

sum of the interest on the acquisition Indebtedness plus the interest on the home equity indebtedness.

### Another Limit

In addition to the other limits described in this article, there is another

#### NOTES

- 1 The reverse mortgages referred to in this article are the Home Equity Conversion Mortgages (HECMs), which were created by Congress, are governed by HUD, and are insured by FHA. More than 95% of all reverse mortgages currently outstanding are HECMs. For more complete discussion of HECMs, see, e.g., Giordano, *What’s the Deal With Reverse Mortgages?* (People Tested Media, 2015).
- 2 This increase is likely to occur as more retirees and their advisors recognize that home equity constitutes a substantial portion of many retirees’ wealth and that it can be used effectively to enhance and stabilize retirement income, and also to achieve the retirees’ other financial objectives set out below. See, e.g., statements by Robert C. Merton, Nobel Laureate in economics, at the 2015 Annual Conference at the MIT Center for Finance and Policy (9/25/15) See [www.youtube.com/watch?v=dpzLR\\_XLto](http://www.youtube.com/watch?v=dpzLR_XLto).
- 3 Although repayment of the loan is *not required* until the borrower permanently leaves the residence, re-

payment of any or all of the outstanding loan debt is *permitted* at any time during the life of the loan.

- 4 A reverse mortgage used to pay part of the purchase price of a home is referred to, in the reverse mortgage industry, as an “HECM for Purchase.” The HECM for Purchase is specifically authorized by the Housing and Economic Recovery Act of 2008 (“HERA”). See, also, HUD Mortgagee Letter 2008-33.
- 5 For brevity, the term “home” will be used in this article to mean “principal residence.”
- 6 Section 163(h)(3)(B)(ii).
- 7 To illustrate, suppose that there is \$250,000 of acquisition indebtedness at the beginning of the first year. At 4%, there would be \$10,000 of interest accrued at the end of the first year. That \$10,000 would be interest on acquisition indebtedness, and hence would be deductible when actually paid. At the end of the second year, there would be another \$10,000 of interest accrued on the acquisition indebtedness plus \$400

of interest accrued on the first \$10,000 of interest. The \$400 would be home equity indebtedness (but not interest on home equity indebtedness). At the end of the third year, there would be an additional \$800 of interest accrued on the two \$10,000 amounts plus \$16 of interest on the \$400 amount. The \$16 would be interest on home equity indebtedness, and hence would be deductible when actually paid.

- 8 The research leading to this finding is amply described in the financial planning literature. See, e.g., Sacks and Sacks, “Reversing the Conventional Wisdom—Using Housing Wealth to Supplement Retirement Income,” 25 *Journal of Financial Planning* 43 (February 2012). See, also, Salter, Pfeiffer, and Evensky, “Standby Reverse Mortgages: A Risk Management Tool for Retirement Distributions,” 25 *Journal of Financial Planning* 40 (August 2012).
- 9 Neuwirth, Sacks, and Sacks, research paper in preparation.
- 10 Section 163(h)(3)(C)(ii).

limit on the deductible interest, which applies when the average debt balance (including both principal and interest) for the tax year exceeds the adjusted purchase price of the home securing the debt. In such case, the amount of “qualified residence interest,” the interest that is deductible, is defined by Temp. Regs. 1.163-10T(c) and (d) to be equal to “the total interest . . . multiplied by a fraction . . . the numerator of which is the adjusted purchase price . . . of the qualified residence and the denominator of which is the . . . average balance of all secured debts.” It is not at all clear from the regulation whether the term “total interest,” within the contemplation of this regulation, means the total compound interest on the debt or only the compound interest up to the limits discussed above plus the simple interest beyond those limits.

In the context of a reverse mortgage, the average balance of the secured debt is likely to exceed the adjusted purchase price of the home only in the following situations: (1) in the case of acquisition indebtedness, many years following the loan transaction, when the interest itself has grown to equal or exceed the initial loan principal; and (2) in the case of home equity indebtedness, many years following the borrower’s purchase of the home, if the appreciation of the home has brought the fair market value, at the time the loan is taken, up to more than double the purchase price.

### Issues Relating to the Alternative Minimum Tax.

The interest on acquisition indebtedness is deductible in computing the alternative minimum taxable (AMT) income, but the interest on home equity indebtedness is not. Thus, home equity indebtedness is doubly disadvantaged as compared with acquisition indebted-

ness: Not only is the amount of home equity indebtedness on which the interest is deductible against other income merely one-tenth as large as the amount of acquisition indebtedness on which the interest is deductible, but also the interest on home equity indebtedness is not deductible in computing the AMT income.<sup>11</sup>

Nonetheless, the accrued interest on the home equity indebtedness still might provide some economic benefit to the taxpayer. The benefit would be the following: By bringing the “regular” income tax down below the level of the AMT, it brings the actual tax amount down to the AMT level, which, because of the AMT rate, is less than the regular tax would have been without the deduction.

### DEDUCTION CONSIDERATIONS WHEN THE BORROWER LEAVES THE HOME BECAUSE OF DEATH

Because there is a greater likelihood that the deduction would be lost when the borrower leaves the home because of death than because of any other reason, attention will first focus on how the heir(s) can benefit from the interest deduction.

#### When Can the Interest Be Deducted?

Because most individual taxpayers are cash method taxpayers, the interest can be deducted only when it is paid. Generally, the interest is paid when the borrower permanently leaves the home, the home is sold, and the reverse mortgage is paid off. Very often this is by reason of death, and it is the heir of the borrower who can benefit from the deduction. Of course, however, the reverse mortgage is also paid off if the borrower permanently leaves the home while still living, because he or she is no longer able, or no longer willing, to continue living in the home. As discussed below, there are certain situations in which the borrower himself or herself might pay off some or all of the reverse mortgage loan and take the interest deduction, either upon leaving the home or even, in rare circumstances, while staying in the home.

#### Provision that Allows the Interest to Be Deductible by the Heir(s).

The provision that allows the heir(s) to claim the interest deduction is Reg. 1.691(b)-1, which reads, in relevant part:

1.691(b)-1. Allowance of deductions and credit in respect of decedents. – (a) Under section 691(b), the . . . interest . . . described in sections . . . 163 for which the decedent . . . was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid –

- (1) As a deduction by the estate; or
- (2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest devise, or inheritance from the decedent acquires, subject to such obligation, an interest in property of the decedent . . .<sup>12</sup>

Close reading of the regulation indicates that some careful planning is necessary. From a practical standpoint, what often happens is that the estate plan, or the estate or trust administration, does not treat “holistically” the disposition of the decedent’s home (by means of a will or trust) in conjunction with the disposition of the decedent’s IRA or 401(k) account (by means of a beneficiary designation). As a result, the executor or administrator of the estate, or the trustee of the trust, gathers the decedent’s assets, liquidates them, and then distributes the net proceeds to the heirs. These assets often include the home, but not the IRA or 401(k) account. In such situations, the estate or trust may not have much (or any) taxable income, and hence, when the home is sold by the estate or trust, and the reverse mortgage debt is paid off, most or all of the interest deduction is lost.

Notice that the language of the regulation allows only the heir to have the deduction “if the estate was not liable to pay such obligation.” The typical provisions for paying off the reverse mortgage obligation following the death of the borrower allow the heirs, the executor, or the trustee of the borrower, to arrange for the disposition of the home and pay the obligation. Thus, the estate would be liable to pay the obligation *only* if it arranges, and agrees, with the lender to dispose of the home and make the

#### NOTES

<sup>11</sup> Sections 56(e) and (b)(1)(C)(i).

<sup>12</sup> The applicable sections of the Code are Sections 691(b), 163(h), and 280A. Reading these sections, without going outside the Code, one could very well deduce that the heir(s) of a borrower, to be able to claim the deduction, would have to move into the borrower’s home, make it his or her (or their) “residence,” for at least 14 days and not engage in repair or maintenance for at least 14 days.

payment, and actually does dispose of the home and make the payment.<sup>13</sup> (Furthermore, because the debt is non-recourse, it would not be reasonable for the estate to be liable for the obligation if the home is passed directly, in kind, to the heir(s), subject

of the decedent, they could take a distribution from such account to match the remaining amount of the deduction. Otherwise, some or all of the deduction would be lost.

It may be possible, under some states' probate laws, that the execu-

tor or administrator could choose whether to sell the home or transfer the home in kind to the heirs. If the home is held in a trust, standard trust provisions generally allow a trustee to decide whether or not to sell trust assets, so long as such decision is determined to be in the best interests of the trust beneficiaries.

## Those most benefitted by the uses of the reverse mortgage loans are the "mass affluent" retirees.

to the obligation.) There does not seem to be any way, in the scenario in which the estate or trust sells the home, that the estate or trust could transfer the unused portion of the interest deduction to one or more heirs, for use against their income in respect of a decedent (e.g., the IRA or 401(k) account) or against any other income such heir(s) might have.<sup>14</sup>

The practical suggestion to estate planners and probate attorneys, especially those dealing with mass affluent retirees, is to be sure that, if all other things are equal, the arrangement is such that the interest deduction can be best used, and not lost. In many (perhaps most) cases, the most straightforward way to achieve this result is for the home to be transferred in kind to the heir(s) of the borrower. The heir(s) would then sell the home and be entitled to the deduction. (Alternately, if one or more heirs want to continue to own the home, the reverse mortgage debt could be refinanced with a conventional mortgage, and the refinancing would constitute the payment that would entitle the heir to the deduction.) If the heir(s)' taxable income is less than the amount of the deduction available and the heir(s) are also the beneficiary(ies) of an IRA or 401(k) account

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### **DEDUCTION CONSIDERATIONS WHEN THE BORROWER LEAVES THE HOME BEFORE DEATH**

There are many situations in which a retired borrower would leave the home before death, sell the home, and pay off the reverse mortgage. Obviously, these situations include, but are not limited to, those in which the borrower's health no longer allows the borrower to live on his or her own, or where there is a desire to move closer to adult children, or into a retirement community, etc. In the event of such a sale, of course, the borrower would obtain the income tax deduction himself or herself. The deduction could, as noted above, be used against any taxable income that the borrower may have in that year. Also, as noted above, there does not appear to be any way that the unused portion of the interest deduction can be carried

### **DEDUCTION CONSIDERATIONS WHEN THE BORROWER PAYS OFF SOME OR ALL OF THE REVERSE MORTGAGE DEBT WHILE STILL IN THE HOME**

What about a borrower who wishes to pay off a part of the reverse mortgage debt while still living in the home? Consider a retired borrower who is receiving taxable income from Social Security and a rollover IRA, and also may have some after-tax accumulated wealth. Suppose that the borrower has used a reverse mortgage credit line, either to help purchase the home (as in the first example below) or to augment his taxable income (as in the second example below), or both. As a result of the reverse mortgage, he has accrued some interest, perhaps a sizeable amount of interest. The borrower would now like to use some of his taxable income, or some of his accumulated wealth, to pay down a portion of the reverse mortgage debt,<sup>16</sup> thereby obtaining an in-

#### NOTES

<sup>13</sup> HUD Handbook, 43301, 13.33 and 13.34. The time allowed for such arrangements is initially three months, but can be extended up to 12 months, in three-month increments. See, also, standard HECM promissory note, section 7(A).

<sup>14</sup> A possible exception, but one that probably has little utility and certainly has little flexibility, comes from the provisions of Section 642(h)(2) and Regs. 1.642(h)-2 and 1.642(h)-3. These provisions allow "excess deductions" to be used by beneficiaries, but

only by those beneficiaries, and under only those circumstances, described in the regulations.

<sup>15</sup> When the home is sold, any capital gain realized is subject to income tax, but, where applicable, the gain is also eligible for the \$250,000 or \$500,000 exclusion under Section 121. Because the reverse mortgage debt is non-recourse, when the debt exceeds the value of the home, the disposition is nonetheless treated as a sale under Section 1001, and the full amount of the debt is treated as the proceeds real-

ized. The fair market value of the home is irrelevant, and the cancellation of indebtedness provision of Section 108 does not apply. *Tufts*, 461 U.S. 300, 51 AFTR2d 83-1132(1983); IRS Publication 4681, at p. 4; See, also, Geier, "Tufts and the Evolution of Debt Discharge Theory," 1 Fla. Tax Rev. 115 (December 1992)

<sup>16</sup> As a practical matter, the reverse mortgage debt would not be entirely paid off, but instead at least a token amount, such as \$100, would be left owing, so that the credit line would not be closed.

come tax deduction for the interest portion of the amount used to make the payment.<sup>17</sup> He would immediately borrow back from the reverse mortgage credit line the amount he had paid. He would then be in exactly the same economic position, at least from the “cash in hand” standpoint and the total debt standpoint, as before the transaction, except that his tax bill would be lower.<sup>18</sup>

Another way that the borrower could proceed would be to borrow from a third-party lender the amount to pay down a portion of the reverse mortgage debt, rather than use any of his income or accumulated wealth, and then make the payment, immediately borrow back from the reverse mortgage credit line the amount previously borrowed from the third-party lender, and re-pay the third-party lender. Again, at the end of this transaction, he would be in exactly the same economic position, at least from the “cash in hand” standpoint and the total debt standpoint, as before the transaction, except that his tax bill would be lower.

It seems quite clear that such a transaction, done either way, would not survive scrutiny under the “economic substance doctrine.” The economic substance doctrine is a common law doctrine that has been codified as Section 7701(o). The codified form of the doctrine applies to individuals only if the transaction is “entered into in connection with a trade or business or an activity engaged in for the production of income.”<sup>19</sup> However, the statutory language provides a concise expression of the doctrine, as follows:

[Such transaction shall be treated as having economic substance only if –

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.<sup>20</sup>

It is amply clear from that language that, because the transactions described do not change the taxpayer’s economic position at all (apart from lowering his federal income tax bill), the interest deduction would not be allowed under those transactions.

Suppose, instead, that the final step in the set of steps described in the first paragraph of this section is not taken. That is, the individual does not borrow back from the reverse mortgage credit line the amount he had paid. In that case, the individual is not in the same economic position as he was before the transaction. Economically, he has less cash and less debt. He has simply paid down a portion of his debt, and that payment includes payment of some interest, for which he is entitled to an income tax deduction. It happens to be a payment that he is not obligated to make at that time; but that fact does not seem relevant to the economic substance issue. However, what if he *later* borrows back a similar amount from the reverse mortgage credit line? Does it matter how much later? Is there a subjective question about his intention at the earlier time to borrow later?

Consider another situation: Suppose that the same borrower as described above receives some sort of economic windfall. If the windfall is not subject to income tax (e.g., an inheritance), the borrower might use the money to pay off a portion of the reverse mortgage debt, thereby benefiting from the interest deduction, to the

extent that the deduction is allowed under the limitations and conditions described above. The borrower could then draw an equivalent amount from his IRA or 401(k) account, offsetting the taxable amount by the amount of the interest deduction. He could also use the income tax deduction to reduce or eliminate the tax cost of doing a Roth conversion of some or all of the IRA or the 401(k) account.

In this case, it seems that the borrower’s economic position has changed in a meaningful way. He has less in his IRA or 401(k) account, and has in hand the amount by which his IRA or 401(k) is reduced. He no longer has the amount of the windfall, but that is offset by the amount he has from his IRA or his 401(k) account. His debt on the reverse mortgage is reduced. With those changes in economic position, it is certainly arguable that the transaction meets the requirements of the economic substance doctrine.

One more situation, a rather obvious one, in which the interest deduction on a reverse mortgage can be taken by the borrower while still in the home, is the following: Suppose the homeowner, who is 62 years old, or older, has a conventional mortgage on which he is making regular payments. Suppose, further, that the mortgage is acquisition indebtedness, or that the outstanding principal balance is not greater than \$100,000. If the conventional mortgage is refinanced by a reverse mortgage, the homeowner would have the flexibility to continue to make the regular payments, or to make interest-only payments, or to make payments of any amount, or to make no payments at all. Whenever a payment is made, to the extent of the interest in the payment, it is deductible.

## WHO BENEFITS THE MOST AND WHAT ARE THEIR MAJOR FINANCIAL OBJECTIVES?

The financial planning literature shows that the greater the ratio of home value to the value of the retiree’s securities portfolio, the greater the beneficial effect of strategic coordination between these

### NOTES

<sup>17</sup> Under typical reverse mortgage agreements, a portion of any repayment amount is the repayment of the accumulated “mortgage insurance premiums.” Currently, that portion is treated as interest to the extent that the mortgage itself is treated as acquisition indebtedness. Section 163(h)(3)(E). As of this writing, this Code section is effective through 12/31/16. For further discussion, see, e.g., “Tax Planning and Reverse Mortgages: Deduction Bunching and Loan Payments,” blogs by Dr. Tom Davison at [tcdbdavison.files.wordpress.com/.../tax-planning-with-a-reverse-mortgage](http://tcdbdavison.files.wordpress.com/.../tax-planning-with-a-reverse-mortgage) and at [toolsforretirementplanning.com/2014/04/18/reverse-mortgage-research/](http://toolsforretirementplanning.com/2014/04/18/reverse-mortgage-research/).

<sup>18</sup> From the standpoint of the composition of the debt, i.e., the allocation between interest and principal, he would be in a different position, one with more principal, and less interest, owed. As a result, his (or his heir’s) future payment(s) might have different tax consequences than if the transaction had not occurred. Moreover, since the reverse mortgages considered here are generally subject to variable interest rates, the transaction considered does not constitute a refinancing and does not result in a different interest amounts charged or a different overall amount owed.

<sup>19</sup> Section 7701(o)(B)(5).

<sup>20</sup> Section 7701(o)(1).

two assets in optimizing the retiree's cash flow (and other financial objectives) during the years in retirement.<sup>21</sup> As a result of the limitation on the amount of home value that can be considered for a reverse mortgage, i.e., \$625,500, the "mass affluent"<sup>22</sup> retirees (whose assets and financial objectives are specified below) are those most benefitted, in financial terms, by the use of reverse mortgages during retirement.

### The Mass Affluent Retirees

Those most benefitted by the uses of the reverse mortgage loans, as described in the examples below, are the mass affluent retirees. Typically, the mass affluent have a net worth at retirement in the range of \$1.5 million to \$3 million, well below the level where estate tax is a consideration.

Most often, this wealth consists primarily of two assets: a securities portfolio (usually in a 401(k) account or a rollover IRA); and a home, in some cases encumbered by little or no debt, and in other cases encumbered by more debt than the retiree can comfortably service. For most mass affluent retirees, these two assets have values that are of the same order of magnitude.

Of the Baby Boomer generation's 75 million members, close to 15 million are in the mass affluent category.<sup>23</sup>

### Major Financial Objectives

The major financial objectives of mass affluent retirees are:

1. Cash Flow Survival, i.e., not running out of money during retirement. (The risk of outliving one's money is often termed the "Longevity Risk.")
2. Retaining some financial cushion to be available in the event of financial emergency.

3. Passing something on to heirs and beneficiaries. (This is often termed the "Bequest Motive.")

Now turn to two examples, to illustrate some transactions that use reverse mortgages to advance these financial objectives, to illustrate the determination of the amount of interest that accrues as a result of these transactions, and to illustrate the amounts of accrued interest that are deductible. In both examples, the retirees are typical "mass affluent" retirees.

### FIRST ILLUSTRATIVE EXAMPLE

The first example begins with the following scenario:

A 67-year-old retiree has a rollover IRA worth \$1 million, invested in a typical securities portfolio.<sup>24</sup> He also has a home, with a value of \$1.13 million, with an ordinary mortgage secured by the home, with a \$500,000 outstanding balance (thus, with equity of \$630,000). The retiree wants to sell the current home and downsize to a new home that will cost \$850,000, but he will have only \$600,000 from the sale of his current home, after commission and closing costs. He will need about \$40,000 per year (inflation adjusted) plus Social Security, for living expenses (including income taxes), without needing any amount to service a mortgage.

### Two Ways to Proceed

The retiree described in the opening scenario can proceed in either of two ways to obtain the additional \$250,000 needed to purchase the new home:

1. Withdraw from the IRA (reducing it from \$1,000,000 to \$640,000, i.e., \$360,000 is withdrawn, of which \$110,000 is used to pay the income

- tax on the \$360,000, leaving \$250,000 for the home purchase).
2. Obtain a reverse mortgage loan for \$250,000<sup>25</sup>

For convenience, each of these two ways to proceed will be termed a "transaction," and more specifically, the first will be termed the "IRA Transaction" and the second will be termed the "Reverse Mortgage Transaction."

### Which Transaction Will Better Advance the Retiree's Three Major Financial Objectives?

Of the three major financial objectives specified above (cash flow survival, cushion for emergency, and making a bequest), the first objective is generally paramount. So the focus is on that objective first.

The graphs in Exhibits 2 and 3, generated by Monte Carlo simulation, show the probabilities of cash flow survival under each of the two transactions mentioned above.<sup>26</sup> In each of these graphs, the lowest line shows the probability of cash flow survival (as a function of the number of years following the transaction) when the annual cash amount (in this example, \$40,000, adjusted for inflation) is drawn from the IRA alone. The upper two lines show the probability of cash flow survival when the annual cash amount is drawn from the IRA, but is augmented by draws on the reverse mortgage credit line. The two upper lines show the results of using two different augmentation strategies. Those two augmentation strategies are examined in greater detail as part of the second illustrative example.<sup>27</sup>

The essential point, clear from the graphs, is that the Reverse Mortgage Transaction results in substantially greater cash flow survival probability than the IRA Transaction.

#### NOTES

<sup>21</sup> See, e.g., Sacks and Sacks, *supra* note 8. See also, Salter, Pfeiffer, and Evensky, *supra* note 8. In the context of this literature, "optimizing" means balancing between maximum amount of annual cash flow and minimum risk of cash flow exhaustion, during retirement.

<sup>22</sup> The term is somewhat misleading. It does not mean that they are massively affluent. Instead it means that there is a mass of them, and, in fact, they are better described as "almost affluent." However, the term "mass affluent" has achieved a wide currency in the financial planning community and in its literature, so,

reluctantly, it is adopted here. (See, e.g., Freedman, *Oversold and Underserved—A Financial Planner's Guidebook to Effectively Serving the Mass Affluent*, (FPA Press, 2008).)

<sup>23</sup> Study conducted by Metropolitan Life Insurance Company "Mature Market" division. Private communication.

<sup>24</sup> The portfolio in these examples is made up of six asset classes, allocated in the proportions described in Exhibit 1.

<sup>25</sup> It is clear from the economics of this example that servicing a conventional mortgage would severely burden the retiree's cash flow, leading to an early cash flow exhaustion.

<sup>26</sup> The technique for developing these graphs, using Monte Carlo simulation, is outside the scope of this article, but is amply described in the financial planning literature. See, e.g., Sacks and Sacks, *supra* note 8 and Salter et al *supra* note 8.

<sup>27</sup> The two augmentation strategies are described in Sacks and Sacks, *supra* note 24.

**EXHIBIT 1**

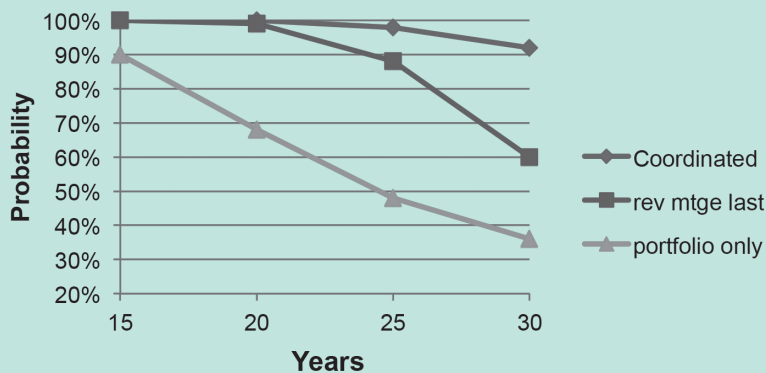
**Asset Classes and Allocation Used in Monte Carlo Simulations**

Asset Class	Percentage in Asset Allocation	Mean Investment Return*	Standard Deviation*
U.S. Large Cap Stocks	40%	8.50%	20.65%
U.S. Small Cap Stocks	10%	9.00%	25.00%
International Stocks	10%	8.00%	24.80%
Long Term Bonds	10%	4.50%	10.80%
Intermediate Term Bonds	15%	4.75%	6.50%
U.S. Treasury 1 yr. Constant Maturity	15%	4.30%	3.00%

Means and standard deviations based on projections used in "Money-Guide Pro" financial planning software.

**EXHIBIT 2**

**First Example: Probability of Cash-Flow Survival Using the IRA Transaction Strategy**



The upper two lines reflect the use of the reverse mortgage credit line to augment income drawn from the securities portfolio (the retiree's IRA), using the Coordinated strategy, and the Reverse Mortgage Last strategy, respectively, and the lowest line reflects income drawn from the portfolio only.

Next, the retiree's other two financial objectives are considered. The same Monte Carlo simulations that were used to generate Exhibits 2 and 3 were also used to estimate the amount of financial cushion available at any time during retirement (i.e., the value of the IRA at that time plus the amount available at that time from

the reverse mortgage credit line) and the amount available for bequest (i.e., the retiree's overall net worth) at any time. Because these are estimates based on Monte Carlo simulations, the longer the time that elapses between the time of the transaction and the time with respect to which the estimate is made, the wider the disper-

sion of the results. The results are clear: The median amount of each of these figures at any time during retirement is substantially greater if the Reverse Mortgage Transaction is used than if the IRA Transaction is used.

Because the Reverse Mortgage Transaction yields better results for *all three* of the retiree's financial objectives than the IRA Transaction, that transaction will be the focus to determine the amount of interest that accrues as a result of the transaction, and to determine the conditions, requirements, and limitations on its deductibility.

Now determine the amount of interest that accrues as a result of the reverse mortgage transaction, or at least make a reasonable estimate of that amount. This estimate is relatively easy to make, given that the loan principal is all taken at the outset of the transaction. Therefore, the problem that exists when different amounts of the loan principal are taken at different times is not present. The interest *rate*, however, is variable. For simplicity, however, assume that, on average, the interest rate is somewhere between 4% and 8%. Therefore, Exhibit 4 contains a table of the interest accrued on the \$250,000 loan amount at each of three interest rates, 4%, 6%, and 8%, for each of five periods, 10 years, 15 years, 20 years, 25 years, and 30 years from the outset of the transaction.

In this example, the \$250,000 borrowed by the retiree is clearly "acquisition indebtedness," because it is used to acquire the new home. As discussed above, the interest on the acquisition indebtedness accrues and compounds. However, the interest on that interest is treated as home equity indebtedness, and the compound interest on that home equity indebtedness is trivial in comparison with the simple interest on the acquisition indebtedness, so it is ignored. In other words, only the simple interest on the acquisition indebtedness is considered.

The table in Exhibit 4 sets out the amounts of the simple interest on the acquisition indebtedness, in separate columns, for the three assumed interest rates, and for the five periods spec-

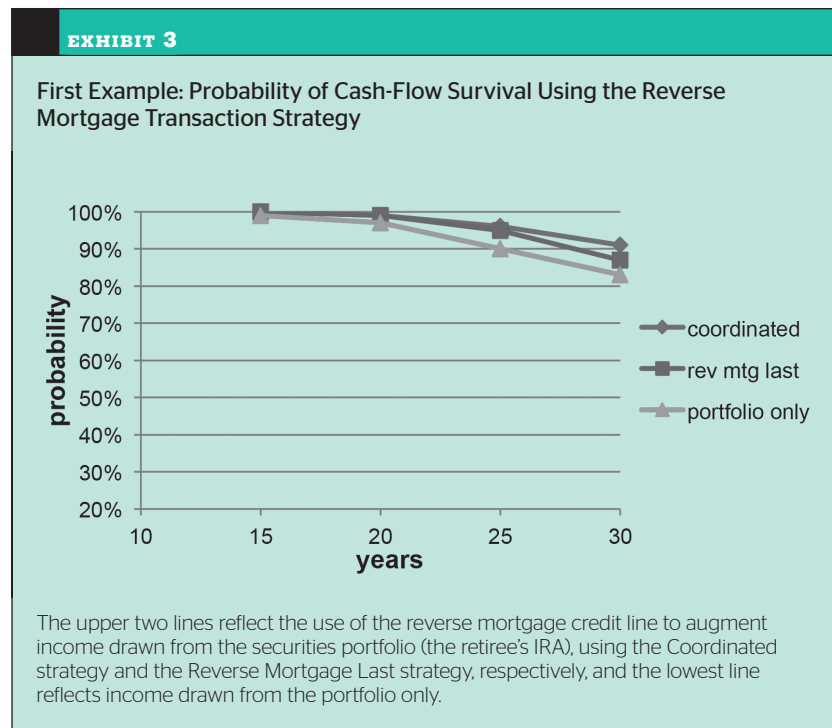


ified above. Clearly, because \$250,000 of acquisition indebtedness is less than \$1 million, *all* the simple interest that accrues on that amount is deductible (when paid).

As noted above, the actual interest rate is variable, and of course is impossible to predict. Therefore, the important thing to recognize is not the precise amounts shown in the table, but the order of magnitude. For example, even after 15 years and at the lowest of the three assumed interest rates, the total simple interest accrued is \$150,000. And after 20 years and at the middle of the three assumed interest rates, the total simple interest accrued is \$300,000. Accordingly, the tax planner should take the necessary steps to assure that the deduction is not lost.

There is one more item to consider before moving to the second example. That item returns to the three objectives described above in the section on deduction considerations when the borrower leaves the home before death. Because the Reverse Mortgage Transaction results in greater amounts in the IRA at any given time (than would be there at that time if the IRA transaction were used), how much would be in the IRA at any time when the Reverse Mortgage Transaction is used? Why is that question asked? Because the IRA could be the very source of taxable income against which the interest deduction could be taken.<sup>28</sup> So, again running the Monte Carlo simulation, the median amount in the IRA is found at the end of each of the five periods, 10, 15, 20, 25, and 30 years from the outset of the transaction. Those results are set out in the table in Exhibit 5. Again, it is true that the longer the period, the greater the dispersion of the results of the simulation. To indicate the extent of that dispersion, the "standard deviation" of each of the result is set out beneath the median result.

Comparing the figures in Exhibits 4 and 5 shows that there is a very high likelihood that, if the retiree or his heir does not have sufficient other income against which to use the interest deduction, there are ample amounts that



**EXHIBIT 4**

**First Example: Interest on Acquisition Indebtedness**

Number of Years	4%	6%	8%
10 Years	\$100,000	\$150,000	\$200,000
15 Years	\$150,000	\$225,000	\$300,000
20 Years	\$200,000	\$300,000	\$400,000
25 Years	\$250,000	\$375,000	\$500,000
30 Years	\$300,000	\$450,000	\$600,000

This table shows the estimated amounts of interest accrued, at assumed average interest rates, under the Reverse Mortgage Transaction described in the First Example

can be drawn from the IRA to take advantage of that deduction.

## SECOND ILLUSTRATIVE EXAMPLE

The second illustrative example begins with the following scenario:

A 67 year-old retiree has a rollover IRA worth \$700,000, invested in a typical securities portfolio. She also has a home, with a value \$900,000, which is owned free and clear (no debt against it). Unlike the retiree in the

previous example, this retiree plans to stay in the home. However, like the retiree in the preceding example, this retiree will need about \$40,000 per year (inflation-adjusted) plus Social

### NOTES

<sup>28</sup> There is no requirement, for income tax purposes, that the IRA (or, indeed, any "income in respect of a decedent") be the only income against which the interest deduction can be taken. However, the beneficiary's other income might not be enough to offset the amount of interest that is deductible, and it does not appear that the interest deduction can be carried back or forward like a net operating loss. So, taking a distribution from the inherited IRA may be the only way the beneficiary/heir can avoid losing some or all of the interest deduction.

## APPENDIX: SALIENT FEATURES OF HECM REVERSE MORTGAGES

A reverse mortgage is a loan secured by the borrower's principal residence ("home"). It is similar to a conventional mortgage, in that the borrower still retains title to the home, and is still obligated to pay the property tax and homeowner's insurance, and to maintain the home. But there are some unique features, the most salient of which are set out below:

1. **Age Requirement:** HECMs are available only to borrowers 62 years of age or older. (If a married couple is the borrower and one of spouses is below the age of 62 at the time the loan is taken, that spouse can be treated as a so-called "non-borrowing spouse" (NBS). If the borrowing spouse predeceases the NBS, the NBS can remain in the home for as long as he or she chooses, but cannot draw any further loan proceeds if the proceeds have not all been drawn. Also, in light of the fact that the NBS is younger than 62 at the time the loan is established, the amount available to borrow is actuarially reduced to reflect that age.)
2. **Loan Amount Available:** The amount of loan available (the "principal limit") is a function of the age of the youngest borrower, the appraised value of the home, and the "expected" interest rate (the value of which is determined by HUD on the basis of the LIBOR 10-year swap rate). The value of the home that is considered in determining the amount available is the lesser of the appraised value or \$625,500. At the current expected rate (as of January 2016) the typical loan amounts available are between approximately 40% of the considered home value (for borrowers in their early 60s) and approximately 65% of the considered home value (for borrowers in their late 70s or early 80s). Thus, a 67-year-old borrower, with a home value of \$625,500 or more, can borrow approximately \$350,000. After the loan is established, the amount available, to the extent not drawn, increases at the same rate as the interest that applies to the amount actually drawn. To illustrate, if the borrower described above does not draw on the loan until he reaches age 72, and average interest rate is 5% during the five-year period leading up to his reaching age 72, the loan amount available at age 72 would be more than \$450,000. (The line of credit established but not immediately drawn upon is sometimes referred to as a "standby line of credit.")
3. **Ways in Which Loan Proceeds Can Be Received:** The loan proceeds can be received in any of three ways, or in any combination of the three ways: (a) as a lump sum at the outset, which may be all or any portion of the loan amount available; (b) as a line of credit, which can be drawn upon in any amount, and at any time, until the amount available has been completely drawn down; and (c) as a series of regular periodic payments, for a fixed number of periods or for the life of the borrower.
4. **Interest Rates:** Generally, the interest rates on reverse mortgages are variable. The exception is that a fixed interest rate can be obtained when the entire available amount of the loan is taken at the outset of the loan. The annual interest rate is most often the one-month LIBOR rate plus a "margin" (fixed at the outset of the loan) plus a "mortgage insurance premium" amount (generally equal to 1.25% of the loan amount borrowed). The margin is usually in the range of 2% to 4%. The higher figure generally will be chosen in exchange for a lower Origination Fee.
5. **Set-Up Fee:** The set-up fee for a HECM includes three components. One component is the Initial Mortgage Insurance Premium," which is equal to .5% of the appraised value of the home (up to a maximum of \$625,500) if 60% or less of the amount available is taken in the first year, or is equal to 2.5% of the appraised value of the home (up to a maximum of \$625,500) if more than 60% of the amount available is taken in the first year. The second component is the Origination Fee, which can be any amount in the range of zero up to a maximum of \$6,000. The amount can be negotiated, as noted in paragraph 4, with a lower Origination Fee in exchange for a higher interest rate. The third component, sometimes called third party charges, include appraisal and survey fees, title and title insurance fees, and credit checks. As a general rule of thumb, these cost \$1000-\$2000.
6. **Must Be the Only Loan Secured by the Home:** The reverse mortgage must be the only loan secured by the home. Thus, if there is a conventional mortgage on the home, a reverse mortgage can be taken only if that conventional loan is first paid off. When the conventional loan balance is relatively small compared to the amount of reverse mortgage loan available, a portion of the reverse mortgage proceeds is used to pay off that conventional loan, as part of the closing process. If the conventional loan balance is slightly larger than the amount available from the reverse mortgage, the borrower may bring some of his own assets to the closing to complete the transaction. The purpose of the reverse mortgage in such a situation would be to relieve the borrower of any future obligation to make mortgage payments.
7. **Borrower Cannot Be Evicted Except for Failure to Pay Property Tax or Homeowner's Insurance, or Failure to Maintain the Home:** Despite residual reports left over from the early days of pre-HECM reverse mortgages, the borrower cannot be evicted from the home for any reason, except for failure to pay the property tax, failure to maintain homeowner's insurance, or failure to maintain the home.
8. **HECM Debt is Non-Recourse:** HECM loans are non-recourse. Thus, neither the borrower nor his or her heirs can be responsible to the lender for any greater amount of debt than 93% of the value of the home. (The 7% figure allows for the costs of sale.) There are many issues, outside of the scope of this article, concerning the tax treatments resulting from the various dispositions of the home when the debt exceeds the fair market value. See note 15 and sources cited therein
9. **When Repayment is Due:** Repayment of a HECM debt is due only after the borrower has permanently left the home. The typical arrangement, as set out in the standard promissory note, is that the borrower, or the family or other representative of the borrower, has three months (which can be extended in three-month increments to a total of 12 months) to arrange for the repayment.

Security, for living expenses (including income taxes).

### Two Ways to Proceed

As in the previous example, there are two ways to proceed. In this example, the two ways to proceed are the following:

1. The retiree could simply draw the \$40,000 per year (inflation-adjusted) from the IRA, and only if and when the IRA runs out of money, she can draw from a reverse mortgage credit line. (This way to proceed is a *passive* strategy, because it reflects a “wait and see” attitude, a hope that the IRA will not run out of money. It can also be called the “Last Resort Strategy,” since it uses the reverse mortgage loan to augment the retirement income only as a last resort.)
2. The retiree could proceed in a more *active* way by taking a reverse mortgage credit line and using it to augment her income in a “Coordinated Strategy.” The Coordinated Strategy uses the reverse mortgage credit line to fill in the troughs in

### EXHIBIT 5

#### First Example: Amounts in the IRA

Number of Years:	10	15	20	25	30
Median Am't in IRA:	\$1,384,000	\$1,565,000	\$1,732,000	\$1,966,000	\$2,180,000
Standard Deviation:	\$601,000	\$1,015,000	\$1,553,000	\$2,317,000	\$3,464,000

This table shows the median values of the amounts in the IRA, in the First Example, if the Reverse Mortgage Transaction is used, after the stated numbers of years. Also shown are the “standard deviations” of those values. Moreover, the simulation shows that the probability of there being more than \$500,000 in the IRA at the end of each period (except 30 years) is 85% or more. At the end of 30 years, the simulation shows that the probability is approximately 81%.

the volatility cycles of the securities portfolio in the IRA. More specifically, the reverse mortgage credit line enables the retiree to *not* draw on the portfolio when it is “down,” thereby enabling a greater recovery of value when it is in an “up” part of its volatility cycle. (This strategy is sometimes described as “offset-

ting the adverse sequence of returns.”)

The algorithm used in the simulation model of the Coordinated Strategy is straightforward: At the beginning of each year, the investment performance of the securities portfolio during the previous year is determined. If the previous year’s perform-

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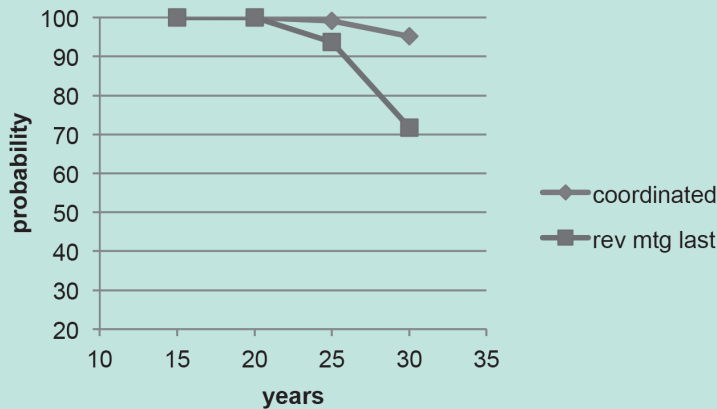
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**EXHIBIT 6**

**Second Example: Probability of Cash-Flow Survival Using the Two Strategies**



**EXHIBIT 7**

**Second Example: Interest on Home Equity Indebtedness**

Number of Years	4%	6%	8%
10 Years	\$31,000	\$39,000	\$47,000
15 Years	\$51,000	\$69,000	\$87,000
20 Years	\$71,000	\$99,000	\$127,000
25 Years	\$91,000	\$129,000	\$167,000
30 Years	\$111,000	\$159,000	\$207,000

This table shows the estimated interest on the home equity indebtedness in the Second Example, resulting from use of the Coordinated Strategy for drawing on the reverse mortgage credit line to augment the income from the IRA.

ance was positive, the current year's income is drawn from the portfolio. If the previous year's performance was negative, the current year's income is drawn from the reverse mortgage credit line.<sup>29</sup>

Referring again to the first of the three financial objectives of the retiree,

as set out above (i.e., cash flow survival during retirement), the graph in Exhibit 6 shows the probability of cash flow survival, as a function of the number of years into retirement, for each of the two augmentation strategies. It is clear that the Coordinated Strategy provides a substan-

tially greater probability of cash flow survival than the Last Resort Strategy. This graph, like those shown in Exhibits 2 and 3, was derived from Monte Carlo simulation. In addition, the same simulation technique shows that the retiree's other two financial objectives have greater probabilities of being achieved when the Coordinated Strategy is used than when the Last Resort Strategy is used.<sup>30</sup>

As in the First Example, the next step is the calculation of the amount of interest accrued under the strategy that best enables the retiree to meet the three objectives, i.e., the Coordinated Strategy. In the Second Example, it is clear that the reverse mortgage loan is home equity indebtedness, and not acquisition indebtedness. Therefore, the interest will compound until the total indebtedness reaches \$100,000, and after that only simple interest will be added.

As in the First Example, the accrued interest will be determined, at each of the three assumed rates, up to the points in time that are 15, 20, 25, and 30 years from the outset of the transaction. This task is a bit more subtle than in the first example, because in this example the draws on the reverse mortgage credit line are not all taken in the first year, and are not all taken in any particular year. In fact, the years in which the draws are taken cannot be predicted precisely; instead, using the Monte Carlo simulation model to estimate, the median year in which the total indebtedness reaches \$100,000 is determined, and then simple interest is computed from that year out to the 10th, 15th, 20th, 25th, and 30th years from the outset of the transaction. It turns out that, for each of the three assumed interest rates, the median year in the Monte Carlo simulation in which the cumulative indebtedness (including the draws on the reverse mortgage credit line plus compound interest on those draws) has reached \$100,000 is the 6th year. It also turns out that the median amount of the portion of that \$100,000 that is the cumulative draw on the credit line, and thus is *not* interest, is about \$85,000. That means

**NOTES**

<sup>29</sup> When the previous year's investment performance is positive but insufficient to meet the current year's retirement income needs, the algorithm provides that the amount of the investment gain is drawn from the portfolio, and the remainder of the retirement income amount is taken from the reverse mortgage credit line. This algorithm and the results it produces are discussed in Sacks and Sacks, *supra* note 8. The reader may ask about the required minimum distributions (RMDs) from the IRA when the Coordinated Strategy algorithm provides that the retiree *not* draw on the IRA. The answer is that the model assumes simply that an identical securities portfolio is established by the

retiree, outside of the IRA, to hold those RMD amounts. Thus, in effect, no disinvestment occurs when the algorithm provides that the retiree not draw on the IRA.

<sup>30</sup> The authors wish to thank Dr. Tom Davison for pointing out that the use of the reverse mortgage credit line in the Coordinated Strategy is "synergistic" with the securities portfolio. That is, rather than being a "zero sum game," where the increase in the securities portfolio would be offset by the decrease of home equity, the use of the Coordinated Strategy results in a long-term increase in the securities portfolio that is, in most cases, substantially *greater* than the decrease of home equity resulting from the debt.

that about \$15,000 of the first \$100,000 of indebtedness is compound interest.

Exhibit 7 shows the estimated cumulative simple interest on the \$100,000 of indebtedness, for each of the five periods described above and each of the three assumed interest rates, plus the \$15,000 of compound interest. In each case, the period over which the interest accrual is calculated is the stated period minus six years. And for each rate, the amount of \$15,000 is added to the simple interest, to reflect the compound interest that had accrued from the outset up through the 6th year. Although the amounts shown in Exhibit 7 are significantly less than the amounts of interest on the acquisition indebtedness from the First Example, they are nonetheless substantial.

As in the First Example, the Monte Carlo simulation is run to calculate the amount remaining in the IRA at the end of each of the five periods considered, i.e., at the end of 10, 15, 20, 25, and 30 years from the outset. The median figures, and a measure of the dispersion, are shown in the table in Exhibit 8. Again, the reason for doing this calculation is to provide a measure of the amount of taxable income against which some or all of the interest deduction might be used, if, at the time the home is sold, the borrower's, or the heir's, other taxable income is not sufficient.

Again, after comparing Exhibits 7 and 8, like Exhibits 4 and 5 in the First Example, it can be seen that there is a very high likelihood that, if the retiree or her heir does not have sufficient other income against which to use the interest deduction, there are ample amounts that can be drawn from the IRA to take advantage of that deduction.

## CONCLUSION

Many retirees will die leaving to their beneficiaries very substantial balances

EXHIBIT 8					
Second Example: Amounts in the IRA					
Number of Years:	10	15	20	25	30
Median Am't in IRA:	\$886,000	\$1,017,000	\$1,163,000	\$1,312,000	\$1,541,000
Standard Deviation:	\$350,000	\$558,000	\$862,000	\$1,375,000	\$2,029,000

This table shows the median values of the amounts in the IRA, in the Second Example, at the end of the stated number of years, when the Coordinated Strategy of drawing on the reverse mortgage credit line is used to augment draws on the IRA. Also, shown are the "standard deviations" of those values. Moreover, the simulation shows that the probability of there being at least \$500,000 in the IRA at the end of any of the five periods is approximately 90%.

in their IRAs or 401(k) accounts. These may very well be cases in which the IRAs and 401(k) accounts have been enhanced, or at least preserved, by using the reverse mortgage for purchase (as in the First Example) or by using strategic draws on reverse mortgage credit lines (as in the Second Example) to offset the deleterious effects of unfavorable sequences of investment returns. These strategic draws augment retirement income and increase the amounts likely to remain in retirement accounts.

The interest on the reverse mortgages is, in general, not actually paid by the borrower as long as he or she lives in the home, so the interest accrues and compounds. Until the interest is actually paid, there is no deduction. Indeed, the deduction seems to be, and may actually be, lost.

The deduction can be "recovered" by the beneficiaries of the 401(k) account or IRA, as heirs to the home itself, if they sell the home and pay off the reverse mortgage, instead of the estate or trust selling the home and distributing the net proceeds. (The conventional approach is to have the estate or trust sell the home and distribute the net proceeds. But the estate

or trust is unlikely to have enough taxable income to benefit from the deduction, and the deduction cannot be transferred.<sup>31</sup>)

The deduction can also be "recovered" by borrowers, in situations in which they have substantial income, or have an IRA or 401(k) account, and they sell the home (e.g., because they can no longer live on their own, or desire to move closer to adult children or into a retirement community) and pay off the reverse mortgage. In such situations, they can use the interest deduction, to the extent allowed (as described above), to offset the income of taking a substantial draw from the 401(k) account or IRA or to offset the tax cost of making a Roth conversion of some or all of the 401(k) account or IRA.

In unusual circumstances, such as the receipt of a windfall, borrowers, while continuing to live in their homes, might be able to pay off a portion of the reverse mortgage debt, and use the deduction to offset the income of taking a substantial draw from the 401(k) account or IRA or to offset the tax cost of making a Roth conversion of a portion of the 401(k) account or IRA. ●

## NOTES

<sup>31</sup> However, see note 14.