Tax Planning and Reverse Mortgages: Deduction Bunching and Loan Payments

Thomas C. B. Davison, MA, PhD, CFP®
NAPFA—Registered Financial Advisor
toolsforretirementplanning.com
tcbdavison@gmail.com

This article discusses two tax planning ideas: First is "bunching" itemized deductions from two years into one tax year. Second is a companion idea: including mortgage interest in your tax planning if you make a payment on your reverse mortgage loan balance.

If have a reverse mortgage you won't have any home mortgage interest to deduct on your tax return unless you pay some of it off, and few people do that. Mortgage interest is often the biggest deduction, and without it may appear your deductions aren't big enough for itemizing to help you, forcing you to fall back on the standard deduction. However, by "bunching" two years of deductions into one year you may be able to double up and trim your taxes. For example, you can pay this year's real estate tax and prepay next year's, getting two years of payments in one tax year. Taxes (state, local and real estate), medical expenses and charity are common bunching candidates. If your potential deductions are $7,000 or more you are a bunching candidate. On the high side, if your deductions are $25,000 a year bunching may not be worth your trouble. Bunching is easy to do once you see the pattern.

Another opportunity comes up any year you pay off part of your reverse mortgage loan balance. That's a great time to proactive consider bunching other deductions with it to get tax savings.

Bunching Tax Deductions

The basics of income taxes are simple: add up your income, subtract personal exemptions and deductions to find your taxable income, look up the tax and pay it. As everyone knows, taxes are not that simple. While it is easy to bemoan the complexity of taxes, complexity's flip side is planning opportunities to reduce your tax bill. One planning opportunity that may become valuable for people with a reverse mortgage is "bunching" itemized deductions into some years and stripping them out of other years. If you refinanced your traditional mortgage or bought a new home with a reverse mortgage you might expect to see a mortgage interest deduction come next April and be surprised not to get the 1098 tax form with the interest amount you can deduct. The reverse mortgage is building up interest, but you can't deduct it unless you pay down the loan balance, which may not be for many years. (If you do pay it down in part or in full, you'll get the 1098). And without a mortgage interest deduction, you may not have enough deductions to itemize and rely on the standard deduction. You may benefit from a different strategy for tax deductions – bunching.

The way deductions work is you add up your itemized deductions and compare the total to the "standard" deduction. As bigger is better, you deduct the larger of the two. Deductible expenses usually fall in four groups: mortgage related (interest, points, and through 2013 mortgage insurance), medical expenses, taxes (state, local, school and real estate), and charitable contributions. Mortgage interest is the largest group, based on national averages. Without mortgage interest you'll likely just have medical, taxes and charitable deductions. If the total of your itemized deductions is smaller than the standard deduction, itemizing won't help. Or if your itemized deductions are just slightly larger than the standard deduction they help, but not much.

Bunching deductions is a strategy that may help. Bunching refers to collecting together all the deductible expenses in one year that you can, and in other years using the standard deduction. When this works well every other year you itemize deductions and in alternate years you use the standard deduction. Between the two years the total amount you deduct is larger.

A good time to think through a bunching strategy is when you are getting your taxes done for the current year, or pulling out your tax return to see what last year looked like. Your deductions are shown near the top of the second page of the Form 1040, and if itemized will be on Schedule A. If your deductible items add up to more than half of your standard deduction, it may be worthwhile to consider bunching.

Bunching Example

For 2013, the standard deduction for a married couple filing jointly is $12,200 to $14,600, with the higher number used for a couple both over age 65. A single filer's standard deduction is $6,100 or $7,600 if over age 65.

Let's look at a sample case of a 66 year old couple who has a total of $14,000 of itemized deductions. Their deductions fall just short of their standard deduction of $14,600, so they get no benefit from itemizing. If they could move just some of their deductions from one year into the next they would be over the standard deduction threshold and get a tax savings. Let's see how that could work.

- Real estate taxes are typically paid once or twice a year. A little known fact is they can be paid early: paid this year for what you will owe next year (or very close – if the taxes go up, you might owe a little bit the next year).
- State and local income taxes can't practically be prepaid (even if you get a refund and apply it to the next year's taxes, it still counts in next year's federal return).
- Charity can be paid a year early. We'll talk about ways to do that later.
- Some medical expenses may be difficult to move, but typically others can.

Deductibles	**No Bunching**	**Bunching deductions every other year**			
	No bunching in 2014	Bring 2015 deductions into 2014	Push deductions out of 2015	Bring deductions into 2016	Push deductions out of 2017
Real estate tax	$4,000	$8,000	$0	$8,000	$0
State & local tax	$1,000	$1,000	$1,000	$1,000	$1,000
Charity	$2,000	$4,000	$0	$4,000	$0
Medical	$7,000	$7,500	$6,000	$8,000	$6,000
Total Itemized Deductions	$14,000	$20,500	$7,500	$21,000	$7,000
Standard deduction	$14,600	$14,600	$14,600	$14,600	$14,600
Itemized bigger than standard ded?	$0	$5,900	$0	$6,400	$0
Tax saving at 15%	$0.00	$885.00	$0.00	$960.00	$0.00
Tax saving at 25%	$0.00	$1,475.00	$0.00	$1,600.00	$0.00

With no bunching in 2014, our couple makes no changes and uses the standard deduction of $14,600, as the total of their itemized deductions added up to $14,000. With bunching by "prepaying" some expenses in 2014, they reduce their taxable income by $5,900. They bunched by prepaying real estate tax and charitable contributions and finding $500 in medical expenses they could advance from 2015. By the end of 2015 they found another $500 of medical expenses that could be comfortably deferred, so in future alternate years they advanced some medical expenses and delayed others.

The value of doing this planning depends on how many expenses you can collect over the standard deduction and your marginal tax bracket. If your annual expenses are less than half of your standard deduction, it won't help unless there is something unusual, such as a spike in medical expenses or income resulting in extra state taxes.

How Do You Bunch Deductions?

Real estate taxes can easily be prepaid – in December send a check for the following year's taxes to your tax authority.

Charitable donations may feel more satisfying if you have one or just a few charities you make larger donations to, rather than many charities that each get smaller donations. And with only a few charities it is easier to bunch them partly because it is easier to keep track of them. You can give money to a charity in one check every other year, or if you want to smooth out cashflow for you and them, in the bunching year you could give them checks in January and December, and no check in the non-bunching year. This pattern works nicely with charities that operate on an academic year from July to June as you will have a donation in every academic year.

A Donor Advised Fund (DAF) is another way to bunch charitable donations. Donor Advised Funds are offered by many organizations. Charles Schwab and Fidelity have funds that can be set up with a minimum donation of $5,000. A DAF is a charity so you get the charitable deduction when you put money into it. As a donor, you advise the fund to make a grant to another charity of your choice - for example to your church, the United Way or any other charity you like. The grants can be done in amounts as small as $50. Your tax deduction happens when you put the money into the DAF, so there is no tax deduction when you make grants. This provides an easy way to double up your charitable donations in a bunching year, and then make grants in any year you want.

Donor Advised Funds were designed to ease charitable donations of appreciated securities – e.g., stock or mutual funds. You get a tax deduction for the security's value the day you donate them. Your donor advised fund will sell the securities and put the proceeds in cash or an investment you chose from their list of offerings. For small charities, like churches, many people hesitate to donate securities directly to the charity because the process may be clumsy or not set up at the charity as it is often handled as a volunteer project. More information on donor advised funds is available on the internet (e.g., schwabcharitable.org, columbusfoundation.org or Wikipedia).

Donating household items to charity is more worthwhile than some people realize. You can deduct "fair market value" for items in good condition. Sample Donation Value Guides are available from the Salvation Army and Goodwill Industries. For bunching purposes you might make a collection in a spare bedroom closet.

State taxes can't effectively be prepaid, but can be "postpaid". To bunch state taxes, you don't make any withholding or estimated payments during the tax year, but early in the next year, before January 15th, you make a 4th quarter estimated payment for the entire year. You will owe a penalty, which in

Ohio for tax year 2013 are less than 2% of the taxes due. As you expect your federal tax savings to be 15%, 25%, or even more, that's a good tradeoff.

Medical Expenses: if you or your spouse was born before January 2, 1949, medical expenses must be over 7.5% of your Adjusted Gross Income to be deductible. If born later only medical expenses over 10% of your AGI are deductible. Getting over these thresholds is another reason to bunch medical expenses.

Timing matters in bunching: in a "bunching" year, you pay all medical expenses you can for the current year and accelerate expenses for the next year; in a "non-bunching" year you delay any you can into the following year. Medical expenses are deductible you pay them. They can be deducted if you pay them before the bill comes, but not before you get the service. If you have dental insurance and get a filling in December you won't see the bill until sometime the next year, but paying the part the insurance company won't cover makes it deductible in December. Some services are more easily moved than others: for example dental visits, new glasses or hearing aids, stocking up on prescription refills before year-end are commonly moveable expenses.

Deductible medical expenses cover a wider range than many people realize. When thinking what you can bunch, don't forget insurance payments, including long-term care insurance. And you can count mileage at 24 cents a mile. For more ideas see IRS publication 502 "Medical and Dental Expenses".

Reverse Mortgage Interest on HECM Loans

If you have a reverse mortgage with a current balance part of the loan balance is interest. The interest is there, but you can't deduct it until you pay it.[i] Some reverse mortgage holders pay off some or all of their loan balance from time to time, and interest is likely to be part of what's paid down.

If you are using the bunching strategy described above, the mortgage interest is another deduction that is easy to "bunch". If you are going to make a payment on the loan, for tax purposes it may work best to do it in a bunching year. Of course a delay in paying the balance down will result in more interest building up. If you are thinking of delaying for bunching you'll want to see which is more valuable: any tax savings or avoiding the loan balance build up.

If you are not routinely using the bunching strategy, consider it the year you make a payment on the loan. See if it makes sense to maximize your other deductions the same year you pay the loan down.

Only part of your loan balance is technically interest, and that's what is deductible. Payments of the loan balance are applied first to the accumulated mortgage insurance premiums, second to any servicing fees you may have, third to accrued interest, and fourth to loan principal. The part of the payment that goes to principal or mortgage insurance is not deductible. When you got the loan, if you financed your upfront fees rather than them pay out of pocket a part of those costs may not be deductible. You may want to check with your loan servicer to see what part (if any) of a payment you make is considered interest. For example, a small payment may all go to mortgage insurance, as that's first in the order.

There are two kinds of mortgage debt: acquisition and home equity. Acquisition debt is used to acquire, build, or substantially improve your main home. So a reverse mortgage used to buy, build or substantially improve your home is acquisition debt. A part of a reverse mortgage that refinances acquisition debt continues to be acquisition debt. Any other debt secured by the home is considered home equity debt. Interest on home equity debt is deductible on up to $100,000 of debt. Interest on acquisition debt of up to about $1,000,000 is deductible, so that's not a limitation for many people!

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Taxes for interest on reverse mortgages generally follow the same rules that apply to regular mortgages. As noted above you have to sort out what is deductible. A standard comment on anything that applies to taxes is there may be other factors that affect your situation, so you may want to consult a tax professional.[ii] Tax rules can change from year to year, and the reverse mortgage could have different provisions depending on when it was issued. There will be additional considerations that apply when the mortgage is finally paid off and closed out.

Cashflow

The bunching strategy uses cash in a lumpy fashion, rather than spreading cash expenditures more evenly through the year. Some years you will have extra outflows at the beginning and end of the year (e.g., 2016 in the example). The in-between years will have smaller outflows. You may need to plan ahead to have the cash available.

Other Deductions?

We've focused on the most common deductions, but not all possible candidates. Among other items are unreimbursed employee expenses, tax preparation fees, and investment interest and expenses. Also, being in Alternative Minimum Tax affects the deductibility of some items, such as taxes. IRS publication 529 has a long list of deductible items (http://www.irs.gov/pub/irs-pdf/p529.pdf).

You Did a Great Job of Finding Deductions – Are You Done?

As the point of deductions is to reduce your taxes, are there other planning ideas to consider? Without launching into a book on tax planning, one idea is that if you have dropped into a lower tax than usual than usual – perhaps because you have not started required minimum distributions from your retirement plans – you might want to recognize more taxable income now rather than later! A Roth IRA conversion is one way to accelerate income. Driving down your tax bill this year is sweet, but driving down your lifetime tax bill is even sweeter.

If you are in the 10% or 15% tax bracket, the tax on capital gains is zero. If you had an appreciated security, you could sell enough to get you near (but not beyond) the top of the 15% bracket.

Disclaimer

Please be advised that, based upon current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty that the IRS might choose to assess related to this matter.

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[i] IRS Publications 554 and 936 state the rule correctly: "Any interest (including original interest discount) accrued on a reverse mortgage is not deductible until you actually pay it, which is usually when you pay off the loan in full." Unfortunately Publication 17 has out of date language, saying interest "is not deductible until the loan is paid in full." For further information see http://reversemortgagedaily.com/2009/02/04/irs-corrects-reverse-mortgage-misinformation/

[ii] Useful references:

1. Blankenship, Vorris J. The Taxation of Reverse Mortgages. Journal of Financial Planning, 2010 http://www.onefpa.org/journal/Pages/The%20Taxation%20of%20Reverse%20Mortgages.aspx
2. Veale, James. Understanding the Tax Implications of a Reverse Mortgage (Part 1 of 2). http://dev.nrmlaonline.org/rms/getting_started.aspx?article_id=626
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