REVERSING THE CONVENTIONAL WISDOM

AN ESTATE PLANNING TECHNIQUE FOR **RECOVERING A LOST DEDUCTION**

© Barry H. Sacks, PhD, JD
Nicholas S. Maningas, Sr
Stephen R. Sacks, PhD

Overview

A reverse mortgage accrues **interest** (in many cases, **lots of it**) over a **long period of time**. It is the **deduction of that interest**, by the borrower, or by the heirs and/or beneficiaries of the borrower, that is our focus in this presentation. We'll **calculate (or estimate) the interest** that accrues in an illustrative example.

Overview (cont'd)

We'll also show a range of **the possible values of the invested assets** in the later years of retirement, with the probabilities of the various values.

The tax law tells us how much of the accrued interest is deductible, and under what conditions it is deductible.

Overview (cont'd)

The conventional approach to dealing with the assets would be to have the estate sell the home and distribute the proceeds. The approach described in this presentation is different from the conventional approach, and may need to be written into the client's will or trust. (In this sense, we are turning away from the conventional wisdom.)

Major Objectives of Mass Affluent Retirees

- Cash flow sustainability, that is, “not running out of money” during retirement. (The risk of outliving their money is often termed the “Longevity Risk.”)

- Retaining some financial cushion to be available in the event of financial emergency.

- Passing on something to heirs and beneficiaries. (This is often termed the “Bequest Motive.”)

Recent scholarly and academic work

Some recent scholarly and academic studies have developed and demonstrated some new strategies to use reverse mortgages to advance all three of these objectives – new strategies that are clever, yet prudent and responsible. The studies have been published in a peer-reviewed journal, the *Journal of Financial Planning,* and in a few academic and professional blogs. Citations to them are given in the endnotes.

This discussion will very briefly describe a couple of these strategies and will use them as illustrative examples. Then we'll turn to the estate and tax planning aspects of each.

Very brief illustration of a **strategy to enable retirees to advance their three objectives**

Illustrative Example:

"HECM for Purchase"

The Scenario:

Retiree's IRA ……..$1 million

Retiree's Home …….$ 1.1 million value with $500,000 mortgage (thus the equity is $600,000)

The retiree wants to sell the home and downsize to a home that will cost $850,000. The retiree will need about $45,000 per year (inflation-adjusted), plus Social Security, for living expenses.

Two ways to proceed

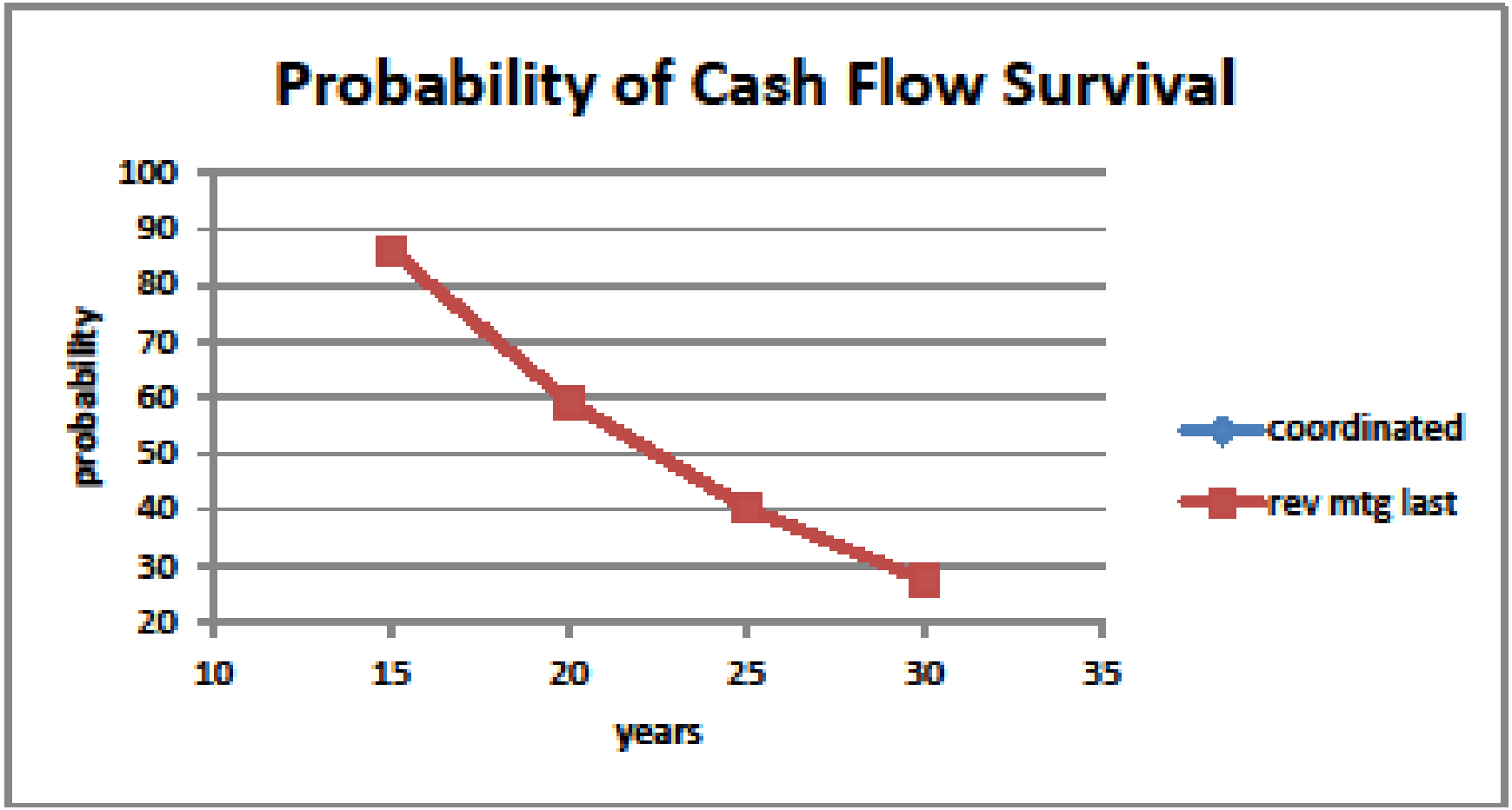
The retiree can proceed in either of two ways, to obtain the $250,000 (in addition to the $600,000 realized from the sale of the old house) to purchase the new house:

1. From the IRA (reducing it to $650,000, i.e., $350,000 is taken out, of which $250,000 is used for the purchase and the other $100,000 is for income tax on the $350,000)

2. Obtain a reverse mortgage for $250,000 (and thus leave the IRA at $1 million)

Which way will better advance the three objectives (cash flow sustainability, a financial cushion, and a bequest)?

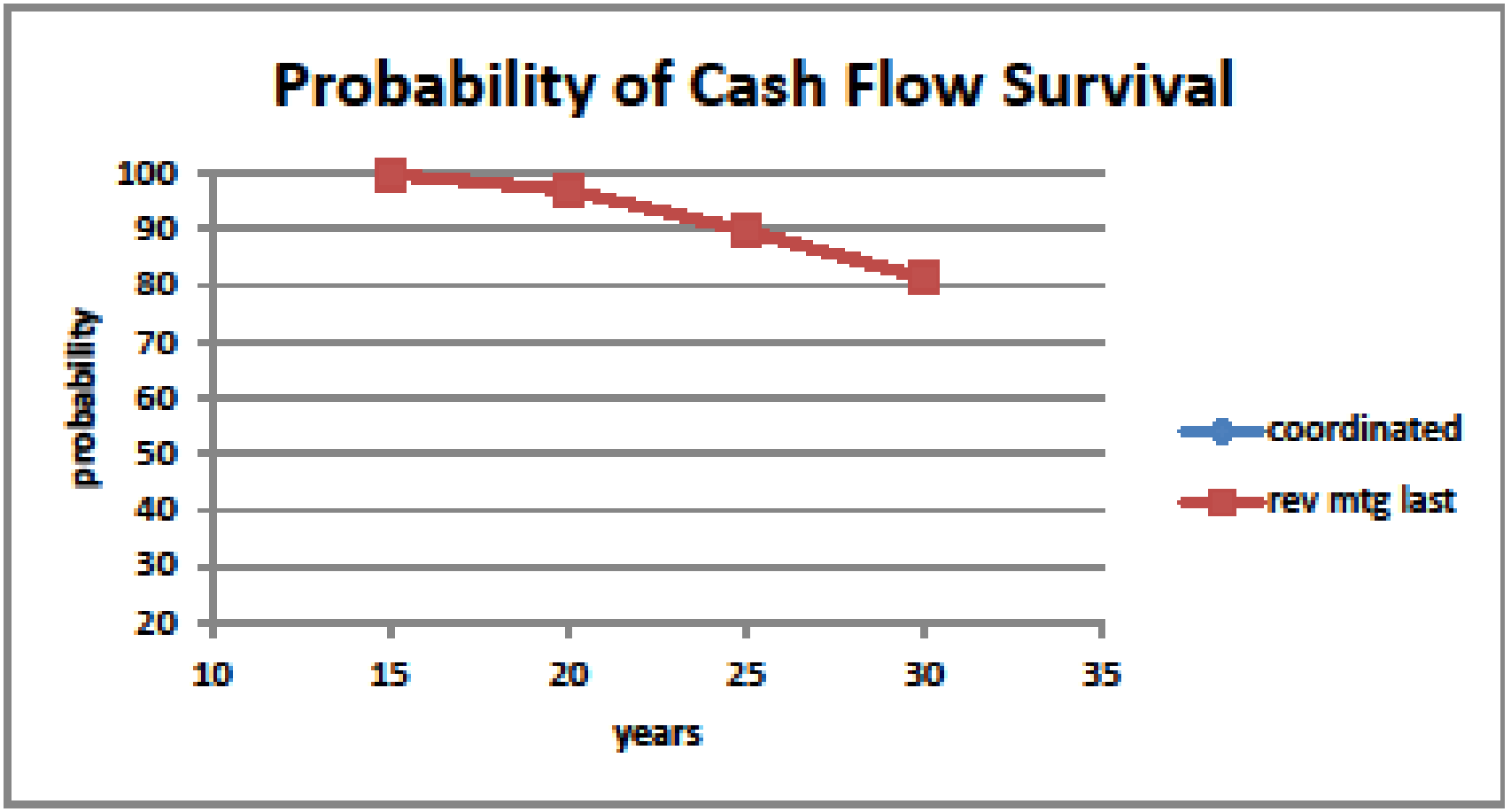
Doing the math is a bit complicated (and a bit outside the scope of this presentation, because our focus is the **interest deduction**), but the graphs below show the results of the math:



This first graph shows the probability of cash flow sustainability if we use the **first way to proceed**, that is, obtain the $250,000 from the IRA:

Clearly, the risk of cash flow exhaustion is far too great. (By taking the $350,000 from the IRA, the $650,000 remaining is far too little to enable it to sustain a $45,000 per year inflation-adjusted distribution for many years.)

The second graph shows the cash flow survival probability if the $1 million is left in the IRA and, instead, a reverse mortgage is taken to obtain the needed $250,000:



This graph shows a very high probability of cash flow sustainability. This second way (using the HECM to purchase)is the **better way to proceed.**

Interest

Since we are focused on the interest deduction, we need to know the interest amount, or at least a reasonable estimate. The interest is easy to estimate: Since the loan principal is all taken at the outset of the transaction, we don’t have the problem that exists when different amounts of the loan principal are taken at different times.

Interest (cont'd)

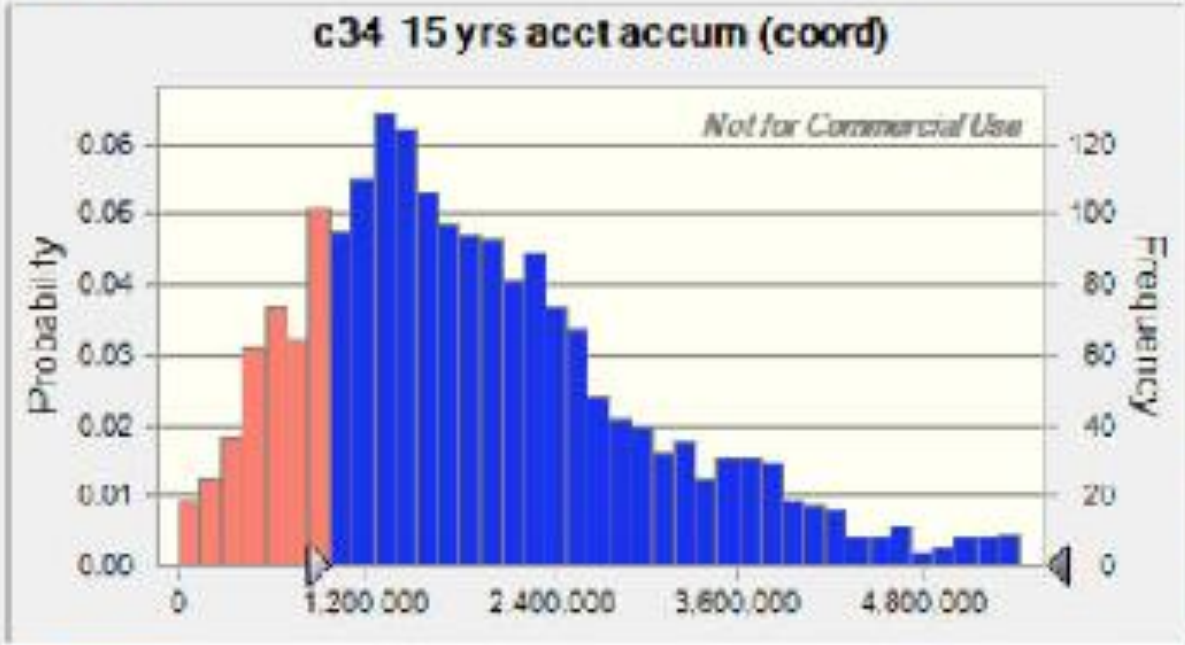
The interest rate, however, is variable. But, for simplicity, let's assume that, on average, the interest rate is somewhere between 6% and 8%. So, below, we see a little table of the **simple interest accrued** on the $250,000 at 6%, 7% and 8% interest, for 15 years, 20 years and 25 years.

	6%	7%	8%
15 years	$225,000	$262,500	$300,000
20 years	$300,000	$350,000	$400,000
25 years	$375,000	$437,500	$500,000

After we look at the rules regarding deduction, we'll apply those rules to see **how much of this interest amount is deductible.**

But, to finish this example, we must ask how much the IRA is likely to be worth in 15 years, 20 years and 25 years. That's not as simple as calculating, or estimating, the accrued interest. A portfolio of securities, particularly one that is being drawn upon, can have any value in a whole range of potential values. The following graphs show the whole range of potential values of the IRA and the probability of each such value, for periods of 15 years, 20 years and 25 years.

2,000 Trials | Split View | 1,966 Displayed

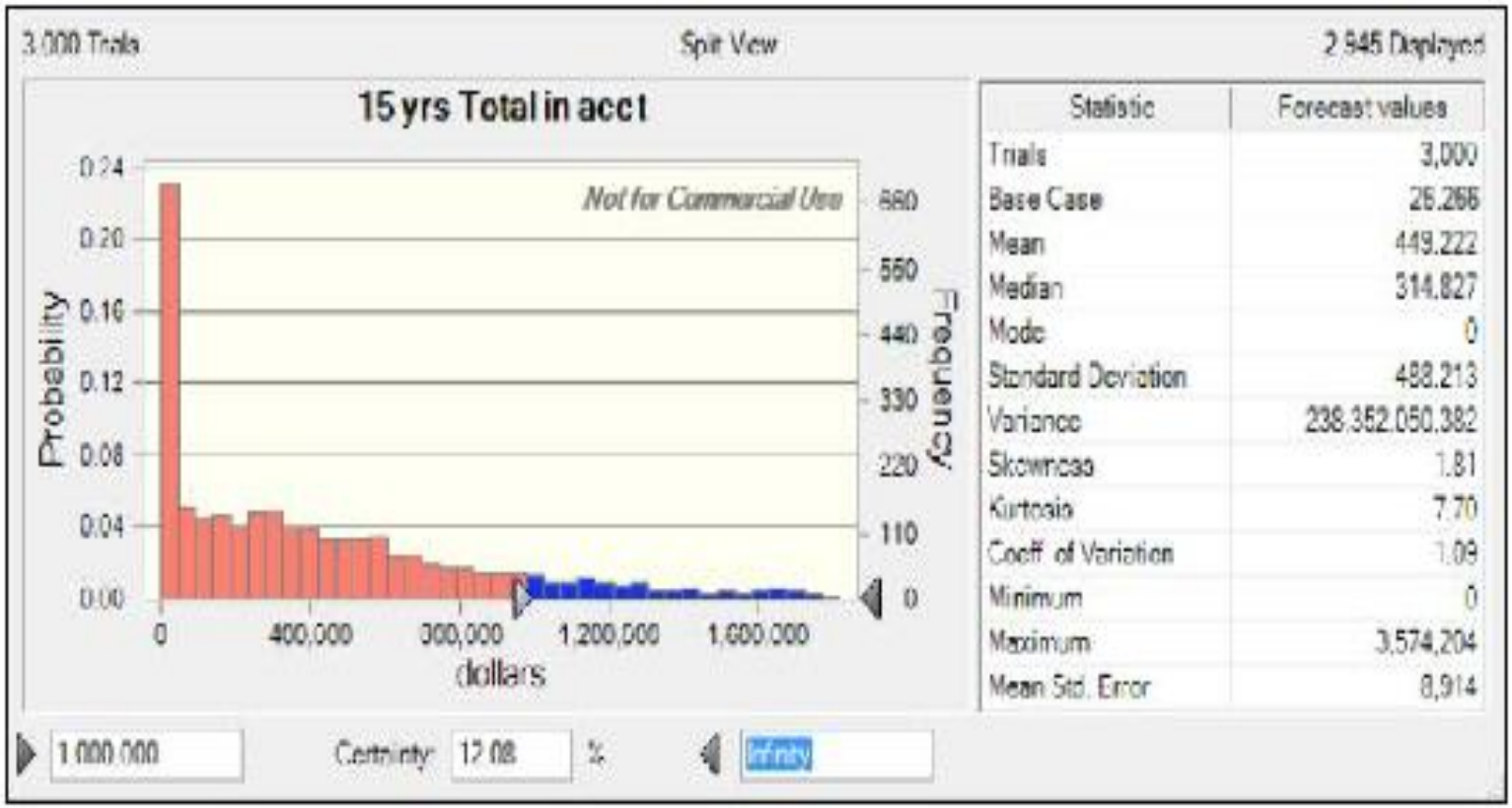


Statistic	Forecast values
Trials	2,000
Base Case	562,827
Mean	1,984,100
Median	1,730,529
Mode	0
Standard Deviation	1,223,498
Variance	1,496,947,517,565
Skewness	1.33
Kurtosis	5.95
Coeff. of Variation	0.6167
Minimum	0
Maximum	10,511,685
Mean Std. Error	27,358

1,000,000 | Certainty: 79.94 % | Infinity

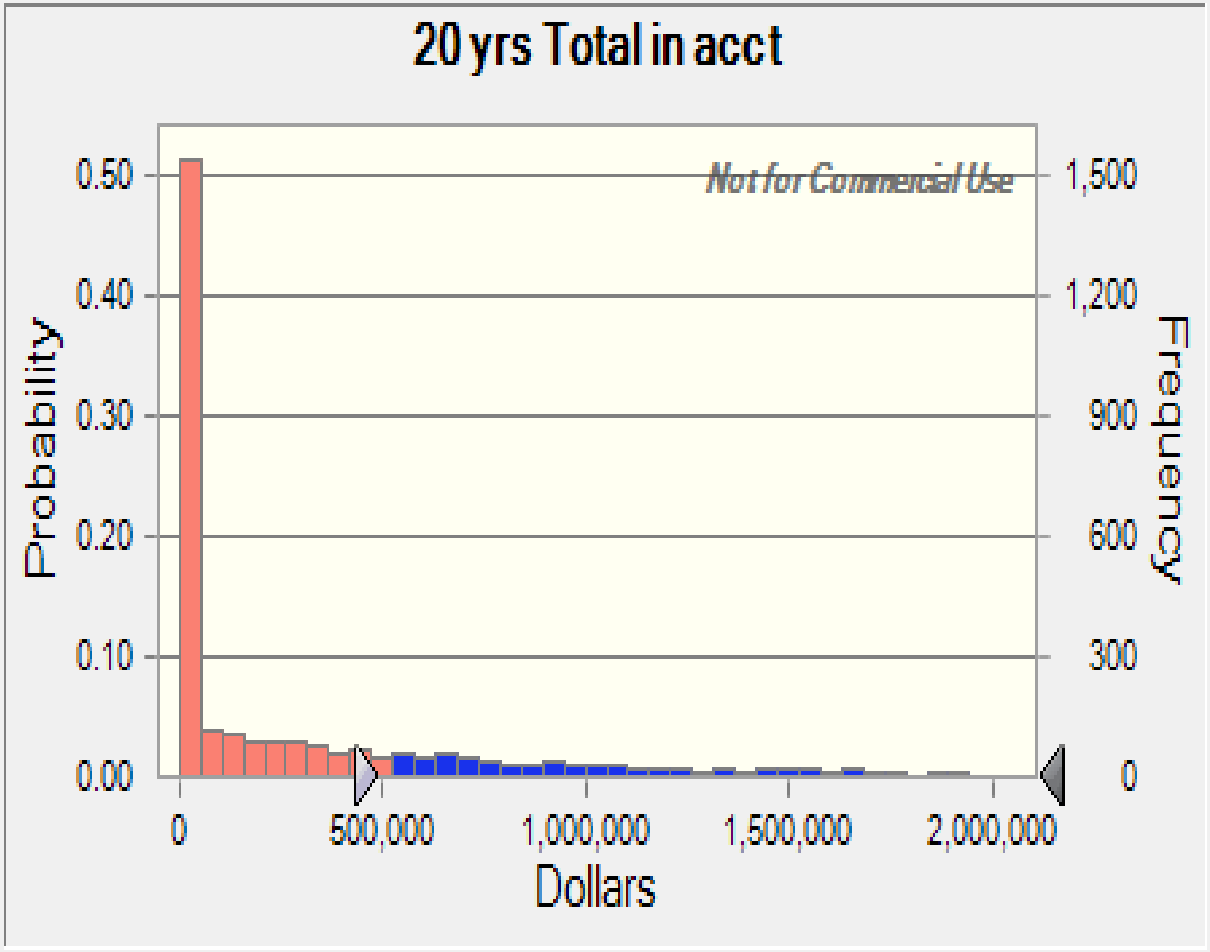
Forecast: c34 15 yrs acct accum (coord)
Trials = 2,000
Certainty = 79.94%
Selected range is from 1,000,000 to Infinity

15 YEARS TOTAL IN ACCOUNT, IRA TRANSACTION



Forecast: 15 yrs Total in acct
Trials = 3,000
Certainty = 12.08%
Selected range is from 1,000,000 to Infinity

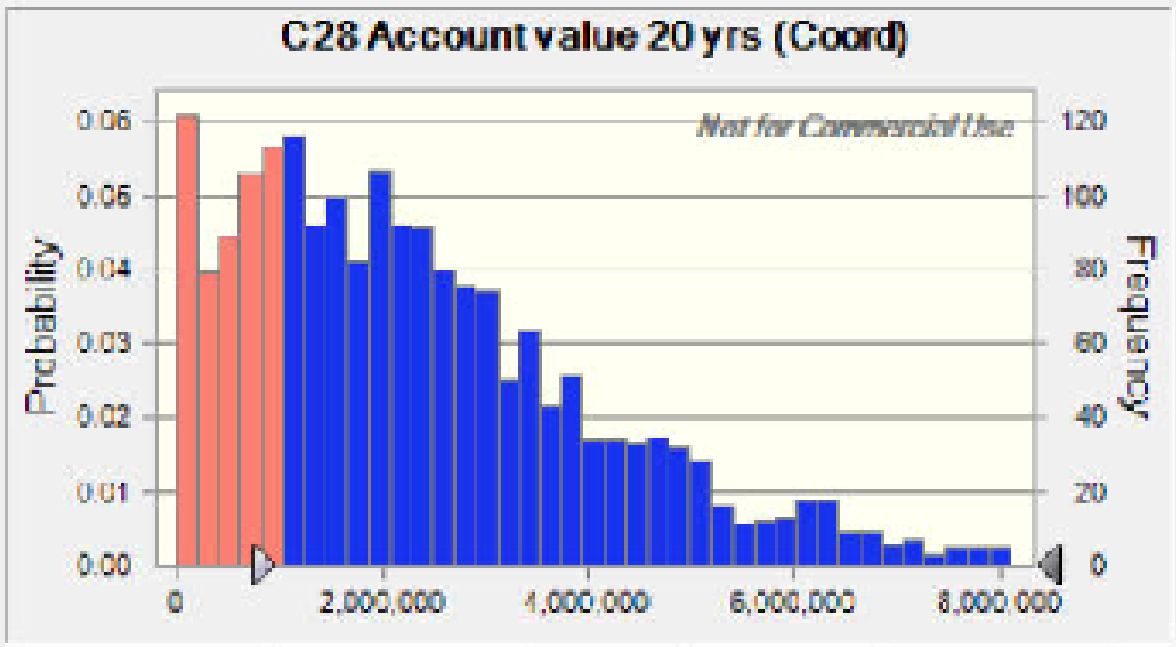
3,000 Trials | Split View | 2,929 Displayed



Statistic	Forecast values
Trials	3,000
Base Case	0
Mean	352,143
Median	28,117
Mode	0
Standard Deviation	606,056
Variance	367,303,603,556
Skewness	2.93
Kurtosis	15.43
Coeff. of Variation	1.72
Minimum	0
Maximum	5,803,175
Mean Std. Error	11,065

500,000 Certainty: 24.70 % Infinity

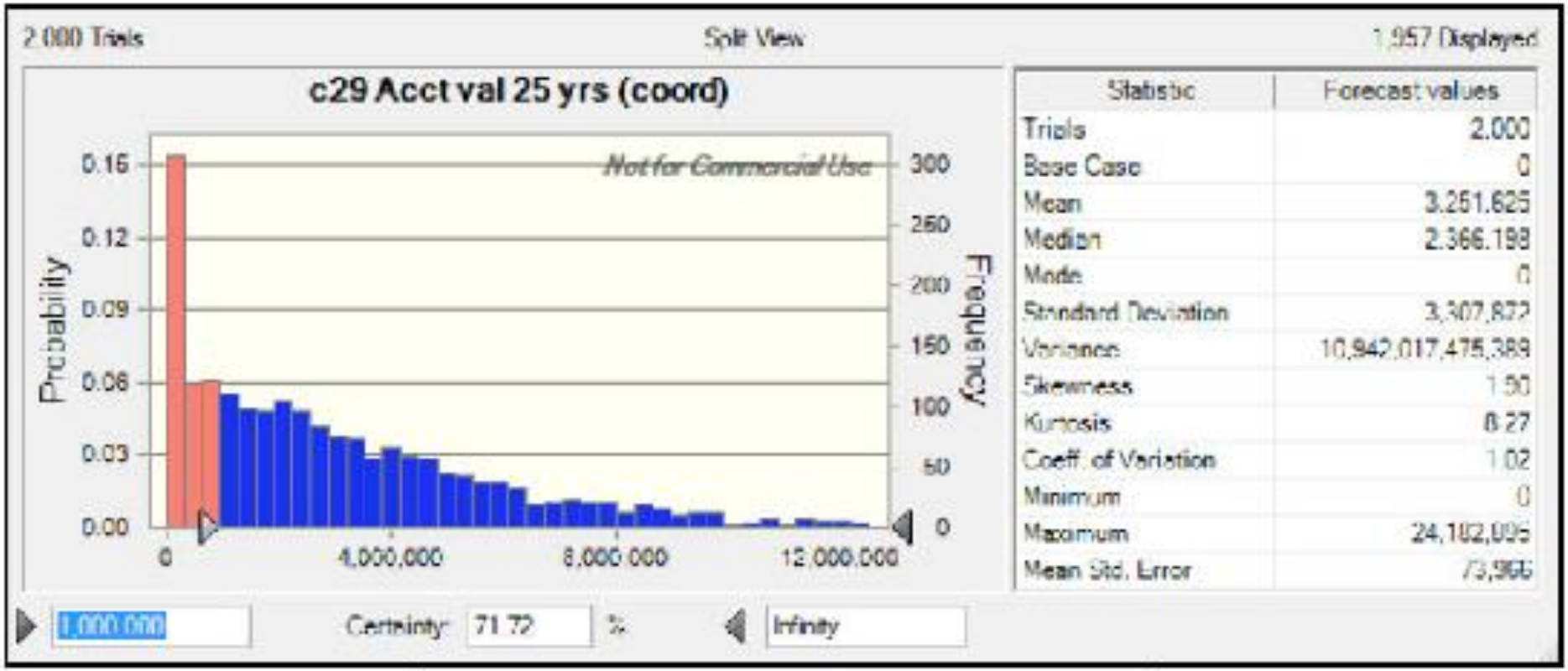
2,000 Trials | Split View | 1,961 Displayed



Statistic	Forecast values
Trials	2,000
Base Case	371,530
Mean	2,489,028
Median	2,072,188
Mode	0
Standard Deviation	2,007,808
Variance	4,031,291,397,908
Skewness	1.55
Kurtosis	6.71
Coeff. of Variation	0.8067
Minimum	0
Maximum	14,340,836
Mean Std. Error	44,896

1,000,000 Certainty: 75.50 % Infinity

Forecast: C28 Account value 20 yrs (Coord)
Trials = 2,000
Certainty = 75.50%
Selected range is from 1,000,000 to Infinity



Forecast: c29 Acct val 25 yrs (coord)
Trials = 2,000
Certainty = 71.72%
Selected range is from 1,000,000 to Infinity

What the graphs tell us…

The thing to note is that, on all three of the graphs reflecting the Reverse Mortgage Transaction, more than 70 % of the potential outcomes are values of $1 million or greater. That means that there is greater than a 70% likelihood that, for the three durations shown, there will be more than $1 million in the IRA. This is true for other durations, as well. These graphs are based on the distribution rate of 4.5%, which is a “sustainable” rate. The same dollar amount, where the IRA Transaction was used, shows a much smaller probability of that amount in the IRA.

What the graphs tell us… (cont'd)

What these graphs tell us is that there is very high likelihood that, if the interest amounts shown above are deductible, then there is plenty of IRA value to against which the deductions could be taken upon distribution from the IRA.

And now we'll learn about the deduction rules.

Summary of the rules governing the **Deductibility of Interest**

A. There are 2 kinds of deductible interest secured by a residence, with different limits and certain other aspects that are different:

1. **"Acquisition Indebtedness,"** which is indebtedness incurred for the acquisition, construction or substantial improvement of a qualified residence of the taxpayer and is secured by that residence. Acquisition Indebtedness also includes any refinancing of such indebtedness, but only up to the limit of the outstanding principal at the time of the refinancing. The amount of Acquisition Indebtedness on which interest is deductible cannot exceed $1,000,000. IRC Section 163(h)(3)(B).

Summary of the rules (Cont'd)

2. **"Home Equity Indebtedness,"** is any indebtedness (other than Acquisition Indebtedness) secured by a qualified residence. The amount of Home Equity Indebtedness on which interest is deductible cannot exceed $100,000. IRC Section 163(h)(3)(C).

There is one additional distinction between the two kinds of indebtedness: In determining the Alternative Minimum Taxable Income, interest on Acquisition Indebtedness **is** deductible, but interest on Home Equity Indebtedness **is not** deductible. IRC Section 56. (This distinction makes a big difference when we apply these rules to our two illustrative examples.)

Summary of the rules (Cont'd)

B. Availability of the Deduction(s) to the Heir(s).

IRC Section 691(b) provides for "deductions in respect of a decedent." Specifically, it provides that deductions under several sections, including Section 163, that are not properly allowable to the decedent shall be allowed to the estate, or if the estate is not liable for the obligation, then to the person who acquires by bequest from the decedent the property subject to the obligation. See, also, Reg. 1.691(b)-1

Summary of the rules (Cont'd)

C. Interest: Compound or Simple?

Before we leave the Internal Revenue Code, it is important to mention that there is a question that the Code does not answer, and neither do the regulations, nor, for that matter, any other authority we have consulted. That question is whether the interest referred to in the Code **in this context** is compound interest or simple interest. As noted above, we take a strict reading of the Code, and view *interest on interest* as *not* interest on Acquisition Indebtedness. For that reason we treat the interest in the First Example as primarily simple interest. Likewise, once the total indebtedness in the Second Example reaches $100,000, we use simple interest.

Application of the **Deduction Rules** to the **Illustrative Example**

The HECM for Purchase Example

1. The HECM for Purchase situation is the ideal situation for the Acquisition Indebtedness treatment. That is, the clear purpose of the reverse mortgage is the acquisition of a personal residence. Under that treatment, the entire amount of the accrued interest is deductible when paid. And the deductibility applies even when the taxpayer (in this case the heir and beneficiary) is in the alternative minimum tax range.

Additional Comments

1. Our focus is on an **income tax deduction.** Therefore, although we have focused on the decedent's IRA or 401(k) account, which, to the beneficiary, is IRD, there is no requirement in the income tax context that the IRC 691(b) deduction ("DRD") be used only against IRD. It can be used against any income.

2. Our focus is on the way that heirs/beneficiaries can "recover" the deduction "lost" to the (homeowner/borrower) decedent. However, there are situations where the homeowner/borrower can recover that interest deduction. The most obvious one is where the homeowner/borrower sells the home (to move into assisted living, or nearer to relatives, etc.). In this situation, it may be advantageous to use the deduction against a distribution from an IRA or 401(k) account, or to use it against the tax which would result from a Roth IRA conversion.