SUMMARY
of
”Recovering a Lost Deduction”

(This is a summary of the salient points of the research paper, “Recovering a Lost Deduction,” by Barry H. Sacks, Ph.D., J.D., Nicholas Maningas, Sr., Stephen R. Sacks, Ph.D., and Francis Vitagliano, M.S. The paper was submitted to the *Journal of Taxation* on November 15, 2015; as of November 21, 2015, I have not yet heard whether or not it has been accepted for publication.)

1. Reverse Mortgages Accrue Interest; No Deduction Until Actually Paid. Reverse mortgage loans accrue interest, generally over long periods of time. Because essentially all the borrowers are cash basis 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, often after the borrower’s death. Other conditions and requirements may limit the obligor’s ability to claim the deduction.

2. How the Interest Deduction is Often Lost. 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. In the conventional approach for passing the borrower’s home equity to the heir(s), the executor of the estate will sell the home, pay off the reverse mortgage, and distribute the net proceeds to the heir(s). Because the estate of a typical decedent we are considering has little or no income, the deduction is lost.[1]

3. The Mass Affluent Retirees. The focus of our attention is on “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.

4. The Major Financial Objectives of the Mass Affluent Retirees. The major financial objectives of mass affluent retirees area:

A. 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.”)

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[1] The income tax deduction for interest on personal residence debt cannot be transferred or carried back or forward. A possible exception, but one that probably has little utility and certainly has little flexibility, comes from the provisions of Internal Revenue Code Section 642(h)(2) and Treas. Reg. Secs. 1.642(h)-2 and 1.642(h)-3. These provisions allow “excess deductions” to be used by beneficiaries, but only certain beneficiaries, and only under certain circumstances, which are described in the regulations.

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

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

5. Illustrative Examples. Two illustrative examples are given, each showing two ways a mass affluent retiree can pursue his or her financial objectives.

A. In the first example, a retired homeowner with a large IRA ($1 million) and a large home with a mortgage outstanding, wishes to downsize to a smaller home on which he will have no debt. After selling the current home, he will need about $250,000 to complete the purchase of the new home. He can obtain it either from the IRA or take a reverse mortgage ("HECM for Purchase"). He will need $40,000 per year (inflation adjusted), plus Social Security, for living expenses (including income taxes). Monte Carlo simulation, using realistic figures, shows that the probability is much higher that all three of the major financial objectives will be achieved if the funds come from the HECM than if the funds come from the IRA.

B. In the second example, a retired homeowner with a $700,000 IRA and a $900,000 home with no debt against it wishes to stay in the home and will need $40,000 per year (inflation adjusted), plus Social Security, for living expenses (including income taxes). He can draw the income from his IRA and/or from a reverse mortgage credit line. He can use the reverse mortgage credit line as a last resort, or he can use it "strategically," i.e., to offset the "adverse sequence of returns" risk. Similar to the previous example, Monte Carlo simulations, using realistic figures, shows that the probability is much higher that all three of the major financial objectives will be achieved if the reverse mortgage is used "strategically" than if the reverse mortgage credit line is used as a last resort.

6. Interest Amounts and Terminal IRA Amounts. Having determined, by the use of Monte Carlo simulation, which approach, in each example, has the better probability of achieving the retirees' financial objectives, we turn to the results of the calculations of the amounts of the interest accrued, and the amounts that the IRAs are likely to reach, for each of several time periods. Also considered are the limits on the amounts of interest that are deductible, because of limits set out in the Internal Revenue Code. It is clear that the amounts of deductible interest accrued, even as limited by those Code provisions, are substantial. The amounts that the IRAs are likely to reach are also substantial. The tables in the paper show these amounts. Of course, these amounts are only estimates. The precise amounts are not important; what is important is the order of magnitude of these amounts.

Any amounts distributed by the IRAs would be treated as taxable income. By contrast with the amounts that could be distributed from the IRAs, the amount of income that the decedent's estate would have would be zero or near zero.

7. Obtaining the Interest Deduction. A careful reading of the standard HECM promissory note shows that the debt becomes due when the lender or lender's representative (for

convenience, we'll just say "lender") notifies the obligor that it is due. Typically, the arrangement for the payment of the debt, following the death of the borrower, is that the family, or the heirs, or the executor, works with the lender and reach agreement about how the debt will be repaid, e.g., who will take care of selling the home, etc. (This process can take from 3 months to 12 months.) Thus, in effect, whoever acquires the home subject to the debt, and agrees with the lender to sell it and pay off the debt, following the death of the borrower, receives the notice and hence is the obligor. This ties in with the applicable regulation, which reads, in relevant part:

"**1.691(b)-1. Allowance of deductions . . . in respect of decedents.** (a) Under section 691(b). the . . . interest for which the decedent was liable, . . . [is] allowed when paid –

(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 . . . "

From this regulation, it follows that the arrangement can be made to prevent the estate from being liable to pay the obligation. Thus, if the heir(s) to the home is (are) also the beneficiary(ies) of the IRA, he or she (or they) can, to the extent of the deductible interest, take a distribution from the IRA and offset that taxable income against the interest deduction. This strategy is how the otherwise "lost deduction" could be recovered.

8. <u>Interest Deduction Obtained by the Borrower While Still Living</u>. The borrower, while still living, can obtain the interest deduction in any of several situations. One is the situation where the borrower sells the home, if he or she moves closer to adult children or to an assisted living facility. Another is the situation where the borrower refinances a conventional mortgage with a reverse mortgage. He then would have the flexibility to make mortgage payments, which would include an interest component which would be deductible, or not make payments.

In this context, it is important to note that the economic substance doctrine would deny the deduction if the transaction does not "change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position . . ."