Recovering a Lost Deduction: (for the borrower or for his or her heirs)

Tax Treatment

1. Interest deduction (for income tax purposes) is the main focus.

2. Interest accrues on a reverse mortgage debt, but is not deductible until actually paid. It can be paid by the homeowner/borrower, while living, before, or shortly after, leaving the home. Often (but not always) the reverse mortgage debt is paid following the death of the homeowner/borrower.

3. We consider both situations.

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The homeowner/borrower, while living in the home, may, at any time, voluntarily pay any or all of the outstanding debt. This payment would result in an interest deduction.

When the homeowner/borrower leaves the home permanently while still living:

He or she must pay off the debt. That is when the income tax deduction is taken. To the extent allowable, the deduction can be used against any income.

If the homeowner/borrower does not have enough other income to be offset by the deduction, but does have a 401(k) account or rollover IRA, a distribution can be taken, or a Roth conversion can be done, effectively tax-free, to take advantage of the deduction.

The distribution or the conversion must accomplished in the same year, because the deduction cannot be carried forward or backward. In that sense, it is not like an NOL.

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Ranges of important values

In the range of 10 to 25 years of duration of the reverse mortgage, the amount of accrued interest allowable as a deduction is in the range of tens of thousands to hundreds of thousands of dollars.

In that same time range, the range of median values of a 401(k) account or rollover IRA that started at $1 million is still in the range of hundreds of thousands of dollars to a few millions of dollars, when the annual draw rate is $45,000 (inflation adjusted).

Thus, there is likely to be ample income available against which to use the deduction.

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Tax Treatment following borrower’s death:

Now switch to the situation where the homeowner/borrower dies while still living in the home. The applicable regulation reads, in relevant part, as follows:

“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 . . .”

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Following borrower's death (cont'd)

The important estate planning or estate administration strategy is to note that, in general, the estate itself doesn't have enough income to take advantage of the deduction. But the heir(s) of the home may also be the beneficiary of the 401(k) account or rollover IRA, and from that source there is likely to be enough income to take advantage of the deduction.