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these loans at current, lower rates. The new mortgages cannot exceed 105% of the current value of the home, including any refinancing costs. Homeowners with multiple loans would qualify so long as the amount due on their first loan is less than 105% of the property's value and the holder of the second mortgage agrees to remain in the second position.

To qualify, a homeowner must:

- Owe between 80% and 105% of their home's value. According to a Zillow analysis, 14.8 million homeowners would qualify under this specification;<sup>1</sup>
- Have their loans backed by Fannie Mae or Freddie Mac; and
- Have a conforming loan. In most areas, that means a loan with an original amount of under \$417,000 or up to \$625,500 in certain high cost areas.

**Help for at-risk homeowners**

The plan will also help homeowners who are either behind on their mortgages, at risk of default, who are already in foreclosure or whose monthly payments are high in relation to their gross monthly income. Lenders would be provided incentives to bring the payment-to-income ratio down to 31%.

**Seniors at risk**

While conventional wisdom holds that most seniors have significant equity in their homes and are not vulnerable to the risks posed to millions of Americans in the mortgage crisis, a recent AARP study states that older Americans are "especially vulnerable."<sup>2</sup> AARP purchased a database

from Experian consisting of a 2.5 million person random sample.

From this data, AARP concluded that Americans age 50 and over hold about 41% of all first mortgages. Moreover, Americans age 50 and over represent about 28% of all delinquencies and foreclosures. This equates to 684,000 Americans of that age group who were either delinquent or in foreclosure (and this number was as of the end of 2007; that number has likely gone up).<sup>3</sup>

<sup>1</sup> "Refinancing Requests Surge after Obama Announces Housing Plan," Retrieved on March 2, 2009, from [www.zillow.com/blog/refinancing-requests-surge-after-obama-announces-housing-plan/2009/02/](http://www.zillow.com/blog/refinancing-requests-surge-after-obama-announces-housing-plan/2009/02/)

<sup>2</sup> Shelton, Alison; "A First Look at Older Americans and Mortgage Crisis"; AARP Public Policy Institute, September 2008

## Is interest paid on a reverse mortgage deductible?

**TAX: Interest paid on a reverse mortgage may be deductible by an individual, estate, or beneficiary depending upon the facts and circumstances.**

**By David M. Fogel, CPA**

*ECP Guest Contributor*

The **Elder Client Planner** has previously discussed the pros and cons of having a reverse mortgage.<sup>1</sup> This article explains the circumstances under which interest expense on a reverse mortgage is deductible.

A reverse mortgage enables an individual 62 years or older to borrow from the equity in the home. The individual continues to live in the home, receiving a lump-sum payment, monthly payments, a line of credit, or a combination of these benefits, without having to sell or transfer title to the home. The loan (plus applicable interest) usually becomes due when the individual sells the home, dies, reaches the end of the loan period, or permanently leaves the home.

Because the reverse mortgage is considered a loan, the amounts received are not taxable. However, since the amounts received are loans, interest accrues. For cash-basis taxpayers, the interest is not deductible at the time it accrues. Rather, it becomes deductible only when it is paid.<sup>2</sup>

Depending upon the situation, questions arise as to whether the interest, when paid, represents qualified residence interest, investment interest, or personal interest, and whether the payment is deductible by the homeowner, the estate, or beneficiaries. Also, if the interest is paid after the borrower's death, a question arises as to whether it constitutes a deduction "in respect of a decedent." The examples below illustrate these questions.

**Example 1**

Arlene is a 65-year old widow who recently inherited her personal residence because of her husband's death. There is no debt on the residence. The house is worth \$400,000, which is the same as Arlene's basis. Social Security benefits just don't allow her to make ends meet. She obtains a reverse mortgage that pays her

\$1,100 per month. She uses the money for her living expenses. At the end of the 15-year term, the loan becomes due, and she pays the lender \$200,000 principal and \$100,000 interest. Can she deduct the \$100,000 interest payment?

Under these circumstances, to be deductible, the interest would have to be "qualified residence interest," which means that the reverse mortgage loan would have to qualify either as "acquisition indebtedness" or "home equity indebtedness."<sup>3</sup> Acquisition indebtedness is any indebtedness which is incurred in acquiring, constructing, or substantially improving the taxpayer's residence, and that is secured by the residence.<sup>4</sup> Home equity indebtedness is any indebtedness other than acquisition indebtedness that is secured by the residence.<sup>5</sup> Acquisition indebtedness is limited to \$1 million, and home equity indebtedness is limited to \$100,000.

Arlene's reverse mortgage loan was not incurred to acquire, construct, or improve her personal residence, but rather to pay for her living expenses. As a result, it is not acquisition indebtedness, but rather home equity indebtedness.<sup>6</sup> Consequently,

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she may deduct the interest attributable to a maximum of \$100,000 of the \$200,000 loan. There are different allocation methods that may be used to determine the amount of interest paid on the \$100,000 portion.<sup>7</sup> The interest is deductible when Arlene pays it.<sup>8</sup> Interest paid on home equity indebtedness is not deductible for purposes of the alternative minimum tax.<sup>9</sup>

**Example 2**

Assume the same facts as in Example 1, except that Arlene dies just before the end of the 15-year term of the loan, and her estate pays the lender \$200,000 principal and \$100,000 interest. Can the estate deduct the \$100,000 interest payment on its income tax return (Form 1041)?

A special rule provides that interest paid by an estate or trust will be treated as qualified residence interest if the residence is a qualified residence of a beneficiary who has a present interest in the estate or trust.<sup>10</sup> Accordingly, if a beneficiary of Arlene's estate uses the property as a residence (e.g., as a second home) after Arlene's death, then the reverse mortgage loan will be treated as home equity indebtedness resulting in the same answer as in Example 1.

What if the residence is held by the estate for investment purposes, rented to a tenant, or held by the estate for distribution to Arlene's beneficiaries, but not used by any beneficiary as a residence? Whether the interest paid on the reverse mortgage is deductible must be determined using the IRS's interest tracing rules.<sup>11</sup> Interest that constitutes qualified residence interest is not subject to these rules,<sup>12</sup> but all other interest expense must be allocated to a trade or business, a passive activity, an investment expenditure, a personal expenditure, or a portfolio expenditure depending upon how the proceeds of the loan were used.<sup>13</sup>

Following these rules, since the proceeds of the reverse mortgage loan were used to pay Arlene's living expenses, the interest would be personal interest and would not be deductible.<sup>14</sup> However, as discussed

below, this conclusion is overridden by the rules governing deductions in respect of a decedent.

**Example 3**

Assume the same facts as in Example 2, except that instead of Arlene's estate paying the lender, her daughter, who is the sole beneficiary of her estate and who inherits the residence, pays the lender \$200,000 principal and \$100,000 interest. Can her daughter deduct the \$100,000 interest payment?

If Arlene's daughter uses the house as a residence (e.g., as a second home) after Arlene's death, then it would seem that the reverse mortgage loan would be treated as home equity indebtedness resulting in the same answer as in Example 1.

However, unlike the special rule that exists for estates and trusts, there is no similar rule for beneficiaries. The determination of whether the property qualifies as Arlene's daughter's residence must be made at the time that the interest on the reverse mortgage accrued.<sup>15</sup>

Assuming that all of the interest on the reverse mortgage accrued before Arlene's daughter inherited the residence, she would not be able to deduct the interest payment. If Arlene's daughter doesn't use the house as a residence, then there does not appear to be any authority for deducting the interest payment. However, as discussed below, this conclusion is overridden by the rules governing deductions in respect of a decedent.

**The IRC §691(b) argument**

Some practitioners contend that where the interest expense on the reverse mortgage is paid after the decedent's

death, it is allowable as a deduction in respect of a decedent (DRD) and is therefore deductible under IRC §691(b) rather than IRC §163(a).

IRC §691(b) provides that any deduction under §§162 (business expenses), 163 (interest), 164 (taxes), 212 (investment expenses) or 27 (foreign tax credit) in respect of a decedent which is not properly allowable to the decedent on his final return shall be allowed as a deduction to his estate,<sup>16</sup> except that if the estate is not liable for the obligation to which the deduction or credit relates, then the person who inherits the property from the estate (subject to the obligation) is entitled to the deduction.<sup>17</sup>

Two precedents have held that interest expense that accrued before death and was paid after death qualifies as a DRD. In Rev. Rul. 71-422,<sup>18</sup> the taxpayer's income tax return was audited and a deficiency was proposed. The taxpayer died before agreeing to the deficiency. After death, the executor of his estate agreed to the deficiency and paid the tax and interest. The IRS ruled that a DRD may include a deduction for which the decedent had a contingent liability at the time of his death. Therefore, the estate could deduct the interest on its income tax return (Form 1041). The IRS ruled that the interest was also deductible on the estate tax return under IRC §2053(a)(3) in determining the value of the taxable estate.

Similarly, in *Estate of Hooks*,<sup>19</sup> the decedent had borrowed against the value of three life insurance policies during his lifetime. Prior to his death, interest had accrued on these loans. After his death, the decedent's wife received the death benefits under the policies. The insurance company deducted the principal and accrued interest owed on the loans from the death benefits. The Tax Court held that the interest qualified as a DRD.

Following these precedents, in Examples 2 and 3 above, although the interest on the reverse mortgage accrued before Arlene's death, the principal and interest was paid after her death, and therefore the interest payment qualifies as a DRD. As a result, in Example 2 the estate may deduct the interest on its income tax return (Form 1041) as a DRD,

A DRD may include a deduction for which the decedent had a contingent liability at the time of his death.

Interest paid by an estate or trust will be treated as qualified residence interest if the residence is a qualified residence of a beneficiary who has a present interest in the estate or trust.

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and in Example 3 Arlene's daughter may deduct the interest on her income tax return as a DRD. However, the interest expense is subject to the same limitations under IRC §163 as would have existed if Arlene had paid the interest during her lifetime.<sup>20</sup> In both situations, the interest would be treated as interest on home equity indebtedness, which is the same as if Arlene had paid the interest during her lifetime. Thus, IRC §691(b) overrides the conclusions reached in Examples 2 and 3, above.

**Conclusion**

The three examples in this article are only a few of the situations where the deduction for interest paid on a reverse mortgage may be limited. There are literally dozens of different fact patterns that could change the results. Knowing the rules for qualified residence interest and DRDs will help you determine to what extent interest paid by your clients on such mortgages is deductible. **S**

**About the author**

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- 1 Renée Rodda, "Reverse mortgages provide cash, but beware," **Elder Client Planner** (August 2004); Renée Rodda, "More options available for clients considering a reverse mortgage," **Elder Client Planner** (April 2007); Lynn Freer, "Reverse mortgages: lifetime annuity, lump-sum or both?" **Elder Client Planner** (August 2008)
- 2 Rev. Rul. 80-248, 1980-2 C.B. 164
- 3 IRC §163(h)(2)(D) and (3)
- 4 IRC §163(h)(3)(B)

- 5 IRC §163(h)(3)(C)
- 6 IRS Pub. 936 (2008), p.4; Temp. Treas. Regs. §1.163-10T
- 7 Id., pp. 10-13
- 8 See Note 1
- 9 IRC §56(b)(1)(C)(i) and (e)
- 10 IRC §163(h)(4)(D)
- 11 Temp. Treas. Regs. §1.163-8T
- 12 Temp. Treas. Regs. §1.163-8T(m)(3)
- 13 Temp. Treas. Regs. §1.163-8T(a)(4) and (c)(1)
- 14 IRC §163(h)(1); Temp. Treas. Regs. §§1.163-8T(a)(4)(D) and (b)(5)
- 15 IRC §163(h)(3)(A)
- 16 IRC §691(b)(1)(A)
- 17 IRC §691(b)(1)(B)
- 18 Rev. Rul. 71-422, 1971-2 C.B. 255
- 19 *Estate of Hooks v. Comm.*, 22 T.C. 502 (1954, Acq.)
- 20 See the last sentence of Treas. Regs. §1.691(b)-1(a) (taxes must be deductible under IRC §164). See also Rev. Rul. 76-498, 1976-2 C.B. 199 (commissions must be deductible under IRC §212)

**Life insurance paid before death can be tax-free****TAX & FINANCIAL PLANNING: A terminally ill individual may cash in a life insurance policy early.****By Lynn Freer, EA***Publisher*

**A** terminally ill individual may receive cash from a life insurance policy either directly from the insurance company or by selling the policy to a viatical company. In either case, if done properly, the amounts are not taxable to the insured.<sup>1</sup>

Using one of these tax benefits could mean the difference between getting the best medical care, including long-term care, or struggling with medical bills and making choices based on available cash resources.

**Accelerated death benefits**

IRC §101(g) provides that amounts received by a terminally ill or chronically

ill individual are excludable from gross income (i.e., they're treated as an amount paid by reason of the death of the insured). The exclusion applies if the amounts are paid by the insurance company. If the amounts are paid by reason of the sale of the contract, the amounts may be excludable as a viatical settlement (discussed below).

**Terminally ill individual**

The code defines a terminally ill individual as an individual who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification.<sup>2</sup>

Thus, if the insurance contract provides for pre-death payments due to terminal illness, those payments are excludable if the taxpayer meets the definition of terminally ill.

**Chronically ill individual**

The term "chronically ill individual" has the meaning given such term by

IRC §7702B(c)(2) except that such term shall not include a terminally ill individual.<sup>3</sup>

Generally, a chronically ill individual must be certified by a physician or other licensed health care practitioner as unable to perform without substantial assistance at least two activities of daily living for at least 90 days due to a loss of functional capacity, or as requiring substantial supervision for protection due to severe cognitive impairment (memory loss, disorientation, etc.). Thus, a person with Alzheimer's disease might qualify.

Payments to a chronically ill individual under a life insurance contract are excludable from income subject to a maximum of \$270 per day for 2008 or \$98,820 per year (2009 number is \$280 per day or \$102,200 per year).

**Viatical settlement**

An individual may also sell or assign the life insurance policy to a third party (a

See **Terminally ill**, page 9