The Norton Tax Bulletin

Richard E. Norton, E.A., Tax Resolution Specialist
513 North Florence Street, Burbank, California 91505
(818) 842-5927 Fax: (818) 845-6031 E-mail: dick@dicknorton.com

February 23, 2022 **Issue: 2022.1**

Dear Clients, family, and friends,

We are in the midst of tax season, and I felt I needed a break from tax return preparation. So, the time is perfect for putting together my first newsletter for 2022!

Using a Reverse Mortgage as Tax Planning

When you think of the reverse mortgage, you may not think of using it as a tax planning tool. If you are house rich but cash poor, the reverse mortgage can

· give you the cash you desire, and

· save you a boatload of both income and estate taxes when used in the right circumstances.

With a reverse mortgage, you as the borrower don't make payments to the lender to pay down the mortgage principal over time. Instead, the reverse happens: the lender makes payments to you, and the mortgage principal gets bigger over time.

You can receive reverse mortgage proceeds as a lump sum, in installments over a period of months or years, or as line-of-credit withdrawals. After you pass away or permanently move out, you or your heirs sell the property and use the net proceeds to pay off the reverse mortgage balance, including accrued interest.

So, with a reverse mortgage, you can keep control of your home while converting some of the equity into much-needed cash.

In contrast, if you sell your residence to raise cash, it could involve an unwanted relocation to a new house and trigger a taxable gain far in excess of the federal home sale gain exclusion break—up to $500,000 for joint-filing couples and up to $250,000 for unmarried individuals.

The combined federal and state income tax hit from selling could easily reach into the hundreds of thousands of dollars. For instance, the current maximum federal income tax rate on the taxable portion of a big home sale gain is 23.8 percent—20 percent for the "regular" maximum federal capital gains rate plus another 3.8 percent for the net investment income tax. And that's just what you must pay the feds. If you live in California, the maximum tax rate is 12.3%. Some of the other states with income tax liabilities approach that amount. Together with the maximum Federal tax, the seller could lose around 36% of the gain (profit) of the sale!

With the reverse mortgage, you can avoid paying income taxes on the sale. And perhaps even better yet, you can avoid estate taxes.

The federal income tax basis of an appreciated capital gain asset owned by a deceased individual, including a personal residence, is stepped up to fair market value as of the date of the owner's death or (if the estate executor chooses) the alternate valuation date six months later.

When the value of an asset eligible for this favorable treatment stays about the same between the date of death and the date of sale by your heirs, there will be little or no taxable gain to report to the IRS—because the sale proceeds are fully offset (or nearly so) by the stepped-up basis. I personally benefitted from this rule when my mother passed away and I sold her home several months after her passing. She had owned the home with my late father since 1973. She got a step-up in basis when my dad passed away in 2002. Still, had she sold her home while she was still alive in 2019, there would have been a substantial capital gain that would have resulted in a significant tax hit! That is because the home appreciated substantially since its fair market value in 2002 (*which became her basis for a subsequent sale*).

The point of this article is that a reverse mortgage can be a means for an owner to get some of the equity out of a property without losing a potential tax savings that would be achieved if the owner kept the property and it became part of the owner's estate (*with the step-up in basis at date of death*).

I hope that you find the information in this newsletter of value to you.

Very truly yours,

Dick Norton