ALTERNATIVES TO THE REVERSE MORTGAGE

There is a growing problem among our senior citizens. More and more of them are essentially running out of money as they grow older and spend down their investments. Many of them are struggling financially, because of major medical expenses, poor investment decisions, portfolio losses and bad spending habits.

As a result, many of these seniors are turning to their only remaining, their homes, to pay off credit cards, medical bills, and other debt. The reverse mortgage allows homeowners over the age of 62 to convert a portion of the equity in their homes to cash without having to sell the house.

Before approaching a reverse mortgage lender, the homeowner should seek counseling from a local HUD-approved counseling agency or a national counseling agency such AARP. This counseling is required for all reverse mortgages and is intended to inform and protect seniors.

During the counseling session, the senior will learn about other options that might be more appropriate than a reverse mortgage to help them address their financial needs. There are a few options that are of particular interest if the senior wishes to remain in the home and to retain the home in the family for the next generation. This article will explore a few of these options.

TAKE ON A BOARDER

If the home is large enough and the circumstances allow, seniors may wish to take in a boarder who can pay rent and help around the house. The rent will provide additional income and help the owner with expenses that may range from utilities to prescription drugs. In addition, if the arrangement is particularly harmonious, the homeowner and the boarder may derive other psychic benefits.

If the senior requires some assistance with things like cooking, cleaning, and running errands, the boarder may be able and willing to trade these activities for a break on rent. Seniors who require assistance with more personal needs (e.g. hygiene, dressing, eating, toileting, and getting around) may find licensed caregivers who would be willing to live in the home rent free in return for help meeting these needs.

Seniors who pursue this should consult a tax advisor before they take in a renter. They should also use a written rental agreement which specifies the terms of the arrangement.

THE KIDS BUY THE HOUSE

What if the adult children of the homeowner have the economics means to help their parent(s)? If the family wishes to keep the home, then a reverse mortgage is probably not the best way to address the homeowner's financial needs. Reverse mortgages frequently result in the lending institution ultimately selling the house. If the children buy the home, the parents will receive the equity they own in the property. This would give them resources to pay off debt and meet other expenses.

How would this work? The kids buy the house from their parents. The kids then rent or lease the home back to their parents for an amount that would meet the Internal Revenue Service's requirement for an "arm's length agreement" between parties. It would not be appropriate to allow the parents to live in the house rent free, as the IRS

So, what are the disadvantages of this approach? The rent paid by the parents would be considered taxable income to the kids. While the kid's could "forgive" these payments, tax law treats these payments as income, even if the kids forgive them. The IRS will consider the forgiven payments imputed income and the fair market value of rental payments would be considered taxable income to the kids.

THE KIDS GIFT FUNDS TO THEIR PARENTS

To avoid these complexities, the kids could simply give their parents money to help them financially. Such gifts are completely tax-free if they are no more than $13,000 per person annually. So, two adult children could give their mom and dad a total of $26,000 annually.

THE KIDS LOAN THEIR PARENTS FUNDS

If the parents and/or the kids are concerned about one day recovering the monies the parents receive, then the kids could instead lend their parents money to help them pay off debt, pay monthly bills, etc. The loan should be evidenced by a promissory note that includes the interest rate, the schedule of interest and principal payments and security or collateral for the loan (the house in this case). The parents should sign the note in front of a notary.

To avoid income tax and gift tax complications, the loan should be structured with an interest rate that is no less than market rate. The government calls this interest rate the applicable federal rate (AFR). If this rate is charged, the parents will pay interest and the kids will receive taxable interest income.

But if the parents are in a difficult place financially, they may be unable to make payments on a loan. It could also be that the kids don't want to charge their parents interest on the loan. The whole point is probably to help their parents, not burden them with additional payments.

So, what about charging an interest rate that is below the AFR or even zero? When a lender makes a below-market interest rate loan, the IRS treats this as an "imputed gift" to the parents. The "gift" is the difference between the AFR and the interest actually charged. The parents are considered to have paid this difference as "imputed interest." The government requires the kids to report this interest on their Form 1040 and pay tax on it. If the imputed gift to the parents exceeds $13,000 (per person) per year, undesirable gift and estate tax consequences arise.

AVOIDING INCOME AND GIFT TAX CONSEQUENCES

Obviously this is a bit of a mess. Fortunately, there is a way to avoid it. The IRS will permit the kids to side-step the imputed gift and interest incomes tax rules, if the loan to their parents is no more than $10,000. So, for smaller financial needs, this could work for the family. But, if the parents require greater economic support, this won't be adequate.

The kids can loan their parents up to $100,000, but there are some thorny rules that must be navigated. The kids will have no imputed interest income as long as their parents' net investment income is no more than $1,000. If their net investment income exceeds $1,000, the kids' taxable imputed interest is limited to their parents' actual net investment income. In these situations, where the parents are contemplating a reverse mortgage, is not likely that they will have net investment income in excess of $1,000. So, this should not be a problem. The kids should have their parents give them a signed statement (along with a copy of their tax return) disclosing their investment income.

The gift tax aspects of this arrangement require defter planning. The kids need to make the loan to their parents a "demand" loan. This means that they can legally demand full payment at any time.

With this approach, the imputed annual gift amount is equal to the imputed interest for that year. Given the current low interest rates, the imputed gift (under the AFR calculation) will most likely be well below the $13,000 annual limit for tax-free gifts.

What happens if the parents end up on Medicaid? If the kids have loaned their parents money through an unsecured loan, they will never recover these sums. This is most likely undesirable to the kids and their parents. To avoid this scenario, the loan from the kids to the parents could be secured with a trust deed to the house.

While a reverse mortgages may ultimately be the best way for seniors to solve their financial woes, this article has offered alternatives that would allow them to avoid the significant expenses of reverse mortgages and keep their homes.

Terry Donahe is a CERTIFIED FINANCIAL PLANNER™ who works with affluent individuals and families. Cascade Wealth Management, LLC, is a fee only Registered Investment Advisor located in Lake Oswego, Oregon. You may learn more at www.cascadewealth.com. Terry can be reached at (503) 675-4381 or by email at terry@cascadewealth.com.