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Advanced Annuity and Tax Strategies for Retirement Income

Curtis V. Cloke, CLTC, LUTCF, RICP®, Founder of Thrive Income Distribution System, LLC

Editor's note: This article is an adaptation of the live webinar delivered by Curtis Cloke in 2021. His comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2021 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course Advanced Annuity and Tax Strategies for Retirement Income for 1.0 hour continuing education (CE) credit.

By Curtis V. Cloke, CLTC, LUTCF, RICP®, Founder of Thrive Income Distribution System, LLC

We can improve the knowledge about the best and worst uses of annuities because often, there are myths. This article is an advanced discussion, so we will assume that you know basic annuity tax facts.

Breaking Myths and Biases Regarding Annuities

We should have no bent for or against annuities. Instead, we should see them only as one of many financial tools in the toolbox. An annuity is either a good fit based on our knowledge of the products, how they are treated for tax, and how they apply to the situation relative to other products. We should not see them anymore than as a tool. Either the tool fits to fix the project, or the tool does not.

There are many types of annuity products. How many types are there? There are 42-plus. When we hear the word "annuity," often folks who know little about annuities listen to what the media has said about annuities. The media's negative commentary about annuities typically is about one of the 42 products with high fees or other arguable differences.

Yet, other products do not have fee drag and are not taxed in the same way other annuities are taxed. You cannot paint the broad brush of an annuity based on what one annuity does; and yet, it is done every day in marketing campaigns and by folks that want to dismiss annuities as a bad idea.

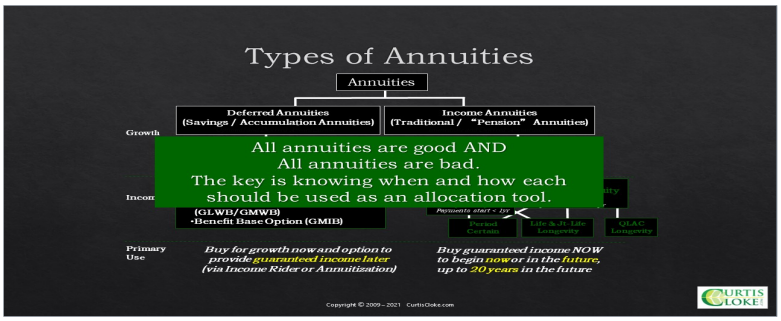
I want to contrast annuities to mutual funds. How many types of mutual funds are there? We do not categorize mutual funds as one segment. We recognize that there is a variety of different types of mutual funds and ETFs. We recognize that there are good mutual funds and bad ones, yet we do not paint the brush of negativity with the word "mutual funds" in a similar light that we do the word "annuities."

Our goal in this article is to recognize the broad formation and the contract structures that exist with annuities.

Types of Annuities

All annuities are good, and all annuities are bad. The key is knowing when and how each should be used as an allocation tool. Also, there are growth annuities that are intended for growth and annuities that are intended for income.

There are two main categories or subsets annuities. They are deferred annuities, which are savings and accumulation annuities; and income annuities, which are traditional income-producing products, or they could be like pension annuities. The only other category that we are not going to focus on today is structured settlement annuities.



Underneath deferred annuities, there are three basic chasses. There are variable annuities, there are indexed annuities, and there is a variety of different terms: fixed index annuities and other terms that we have heard for that. Then there is a fixed rate annuity. Two different types are pretty common.

First is the MYGA, which represents a multi-year guaranteed annuity. That would be like a CD alternative. If you buy a three-year MYGA today, you might earn 2.1% on a three-year rate, which beats the banks by about one percent or 80 basis points. A MYGA is a multi-year guaranteed annuity. What you see is what you get. You get the same rate all three years. Many have a 5% or 10% liquidity provision and then s 30-day window of freedom at the end of the three-year or the five-year, whatever the term is.

Then there are traditional fixed annuities. There are too many variations of that product to describe here. There is a new type of variable annuity called structured annuities. There are a whole bunch of categories under each of these basic types.

Underneath deferred annuities intended for savings and growth are alternative income and death benefit riders that one can layer on, so you can have withd benefit riders like a GLWB (Guaranteed Lifetime Withdrawal Benefit), GMWB (Guaranteed Minimum Withdrawal Benefit), or a GMIB (Guaranteed Minimum In

Benefit). They all work quite differently in terms of how they generate and produce income. All these benefits generally charge some kind of fee drag to allow you to have a guaranteed lifetime income or joint lifetime income on top of whatever the other charges of the annuity are if any.

A primary use for these products is to buy growth now and an option to provide guaranteed income later via an income rider or via an annuitization. That represents the deferred annuity category.

The second category is income annuities. There are immediate income annuities, which we know as a SPIA. For tax purposes and content purposes, SPIAs must start within 12 months. There is a specific tax reason why this is the case.

The second category is deferred income annuities (DIA). I discovered this particular product in 1999. At the time, it was called a deferred SPIA. I actually coined it as a SPDIA: single premium deferred income annuity. That name didn't take off, so we changed and shorted it to DIA. We were the first firm to name that product in the industry.

Payments with a DIA for tax purposes must start after a year. You must delay payments for more than a year, but you can delay that up to 20 years, for example. There is much flexibility between when you purchase it versus when income starts.

With a SPIA, we all know you can buy a period certain payout. You can buy a five-year period certain, a one-year delay and a five-year period certain, a one-year delay and a 10-year period certain. There is much flexibility with period-certain payouts. You can buy a lifetime or a joint lifetime.

The fallacy I repeatedly hear is that insurance companies only allowed you to turn on a DIA for longevity purposes. They would not allow you to do period certains, so the "DIA" was perceived as only a longevity annuity. I hear it coined in articles and all kinds of material, but it is absolutely the most inaccurate thing said about a DIA. Everything you can do with a SPIA, you can do with a DIA. As a matter of fact, from 1999 until 2009, the only thing I did with DIAs was laddered period certains as compared to doing laddered bonds. I found some interesting things in my analytics, testing fee drag and tax drag differences between retaining a present value for a future income stream. That was the most powerful thing. But we must stop calling a DIA just a deferred longevity product. It is a flexible product with a multitude of uses, and it is not limited by longevity only.

The third subset of DIAs called the QLAC (Qualified Longevity Annuity Contract). It truly is a longevity product. What is interesting about QLACs is they are brand new; it is the newest type of annuity we have. The Treasury approved it in July of 2014. The purpose of a QLAC is to buy guaranteed income to begin now or in the future, such as in 20 years.

By the way, there are some products where you can buy a QLAC on a young child. Buy it today and turn it on 30, 40 years from now. I do not know anyone who has ever done that. I have bought it now and delayed up to 20 years. That is the measure by which I will describe this today. Just expand your mind on possibilities.

Age 59½, 10% Penalty Tax Tips and Traps

I mentioned that with SPIAs, you must start the income within 12 months, and with DIAs, you had to start after 12 months. Non-qualified SPIAs do not generate a 10% penalty tax for the taxable portion of the excluded income payments paid before age 59½ for either a short-term period certain or a lifetime income stream. SPIAs for this purpose have a unique tax treatment. Not many advisors know this.

Everybody believes that if you take any gains out of an annuity before 59½, you will naturally pay a 10% penalty tax. This is simply not correct. For non-qualified DIA contracts, however, you do generate a 10% penalty tax for the taxable portion of the income payments paid before 59½ for a short-term period certain, but you do not pay that penalty tax for a lifetime income stream. There is a difference. The reason for this is because for tax purposes, a deferred income annuity that delays more than a year is taxed almost identically to a deferred annuity. Because a deferred annuity is not an income annuity, you can turn it on for a lifetime, have taxable income distributed before 59½, and have no penalty tax. Same with a DIA.

But with a SPIA, this particular provision is waived. It is a unique tax treatment to SPIAs only, and only applies to non-qualified assets. DIAs with a delayed income for a date of deposit are treated as a deferred annuity for tax purposes, unlike SPIAs, which are taxed differently. Not many folks realize this particular point. When doing short-term income bridges, the benefit of using SPIAs over DIAs is sometimes the tax benefits of a high exclusion. This allows a much smaller portion of the asset to be held hostage to generate that short-term sphere of income. In low-interest rate markets, a larger block of assets must be held hostage to generate yield, where you could have a lot more of that portion focused on growth.

Qualified SPIAs and qualified DIAs also do not generate a 10% penalty tax for the taxable portion of income payments paid before age 59½ for all lifetime income streams, regardless of whether it is an installment payment, a cash refund, or there is a variable COLA adjustment to the income payments. Even though 72(t) and 72(q) reference substantially equal payments, there are COLAs that you can buy, such as a one percent COLA, two percent COLA, three percent COLA. All of these are still be within the category of substantially equal payments. This is an alternative to the 72(t) options that exist.

72(t) Regulations Tip and Traps

For qualified SPIAs and qualified DIAs, a five-year period certain income from ages 55 to 60 does not qualify for substantially equal payments under 72(t) as a carve-out from a larger sum of qualified assets.

I hear of advisors starting with maybe a $200,000 IRA account. They think they can take a smaller piece of that $200,000 and then do a five-year period certain payment on a piece of it. Then they grow the rest of the remaining assets between ages 55 and 60, thinking they have met 72(t) because there are two succinct and separate accounts for tax purposes. This strategy does not work for 72(t) whatsoever. All qualified accounts may provide Form 5498 for market value tax d but the income provided by the income-only annuity only satisfies the RMD requirements for that particular SPIA or DIA.

The IRS does not provide for any offset of income payments provided in excess of the 5498 fair market value for the SPIA or DIA. No offset of excess RMDs is allowed for other non-annuity IRA or non-annuity IRA RMDs, even though the 5498 exists. Here is the reason. All annuity contracts approved for issue to be sold in 2006 and after were required to provide a 5498 fair market value to the IRS that included SPIAs and DIAs. SPIAs and DIAs approved for issue to be sold before 2006 were not required to provide the 5498 fair market value to the IRS.

This happened because in 2006, the IRS became aware of death benefit rollup variable annuity contracts. They realized a death benefit to an heir could be $200,000 with the rollup, but the account value might only be $50,000. The client was getting a Form 5498 RMD based on the $50,000 of cash when they could be 90 years of age, die the next day, and the heirs would get $200,000. So, the IRS formulated a special RMD for those products based on the present value, based on age, and based on a formula of the death benefit.

In an effort not to miss any correct 5498 filings, they just simply said all annuities that are qualified must produce a Form 5498. Consequently, you could have an income annuity, a SPIA, or a DIA that does not provide a Form 5498, and you could have some that are providing 5498s. Some tax professionals and others will call me and say, “The income on Box 7, Code 7 of the 1099 is much higher than what the RMD fair market value requires, so cannot we take less from the non-annuitized IRA assets and take an offset?” The answer is, technically, you cannot do that. We can offline have more discussion about this, but that is not allowed given the current IRS Service Regs.

Let us talk just a minute about the QLAC annuities. Qualified longevity annuity contracts were approved for issue by the U.S. Treasury in July of 2014. It allows for 25% of your IRA assets to be invested in a QLAC up to $135,000. A QLAC can be turned on for income at any time. This concept is a point that is missed. Most people think it is age 85. The QLAC Regs allow you to turn it on as early as 72, which now meets the RMD age consequently, but you can delay it and start it anytime you want between ages 72 and 85.

Based on the case study of the client you are working with, there may be reasons why income may want to start at ages 73 or 75 or different ages. You have much flexibility as to when you turn it on the income. Even after you buy QLAC contracts, a lot of them allow you to change the start date to five years later or five years shorter. If you choose a middle ground like age 80, you have maximum flexibility to recast when that starts if you are not sure when you have a gap of income. Just be aware that this feature does exist. QLACs allow for joint lifetime payouts, in addition to just single life. They also allow for a cash refund.

They do not allow for installment payment, but they allow for COLAs. Not many folks understand this. I cannot think of a single QLAC we have ever done that has at least a cash refund on it. The only time a cash refund might not be utilized is if I am arbitraging life insurance purchases along with the income annuity. Then, in this case, I might then do a life-only QLAC. But I do not know of very many clients who would be okay with meeting a MAC truck the day after purchasing a life-only QLAC and kissing that money to their heirs goodbye.

Finally, the IRS allows QLACs to be converted to Roth IRAs, but most carriers do not allow for this change in their administration features for servicing QLAC contracts. Let me pause here for a minute.

Mark Iwry was the second-in-command at the Treasury when the QLAC was approved in July of 2014 to be sold. This approval was before any QLAC product had been developed. It was not highlighted as a benefit in the Regs.

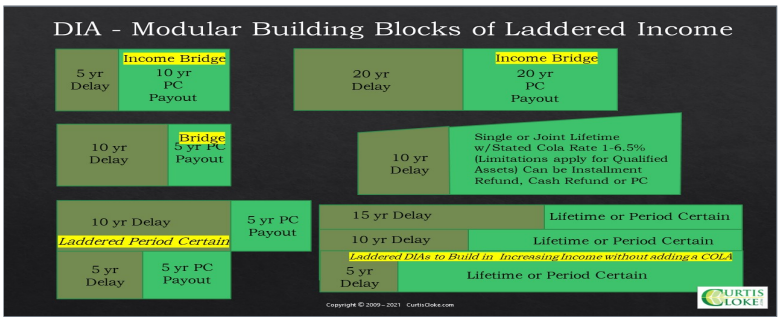
However, the Regs were written so that a QLAC, just like any other qualified account, can be converted, as long as it is the entire contract, over to a Roth. Most carriers that develop these products decide when they develop them what administration allowances they are going to provide to service that product. I have only in my career found one company that was willing to do Roth conversions. We have also converted qualified DIA contracts to Roths.

But because of this possibility and the fact that there may be new developments later, and with all this new thought process, inflexibility of administration possibilities could occur. So, I recommend you consider splitting the QLACs into smaller chunks if there is an opportunity to convert before the income start date to a Roth. The present value of each QLAC would have to fit whatever bracket bumping level you do not want to go over without causing higher taxes from having one QLAC versus many. So, you want that flexibility. This flexibility is magic.

Remember, you can do a QLAC to start in 20, 30, or even 40 years. There is no age limit. The earlier you do it, the more present value there is for RMDs that are pushed further out.

Income Strategies With DIAs

Many folks have not thought about DIAs as I am about to share because they think they are a longevity-only product.



In the upper left corner is a DIA with a five-year delay and a 10-year period certain payoff. We use this as an income bridge. Because we are doing retiremen five or ten years before retirement, we can delegate dollars early and get a discount like buying a discounted bond, in the same idea, same manner. There is an accrual

factor on what my withdrawal rate is to an older age, but with a present value deposited early that gives me a much higher outcome. It holds hostage capital from my fixed-income assets because usually, income annuities are bought with fixed-income assets, not growth assets. There is an advantage to this.

Another option is a DIA with a 10-year delay and a five-year period certain. Or you can do laddered period certains by doing a five-year delay, a five-year certain period; a 10-year delay, five year certain. Like an accordion, you can do a 20-year delay and a 20-year period certain payout. You can do a 10-year delay with a single or joint lifetime. You can also add a COLA.

For example, in 2009, I bought a DIA with a 20-year delay in an all-cash balance pension plan. It was not going to any have new funds added to it. It was locked in at a three percent fixed rate. I could not invest the money. It was part of my fixed-income portfolio.

I put in $52,660. It does not start income payments until July 7, 2029. When I turn it on after 20 years, I will receive five annual payments of $49,797.87. It is a 25-year contract—twenty years of delay, five years of payoff.

I went out this morning on the quoting software inside our retirement income planning software, piped in from Cannex. I wanted to see how much I would need to invest in having an annuity that started paying in January 2029 with a five-year payout of $49,797.87 a year. I would need to invest about $200,000 today to generate the same amount of income.

By the way, if this is the present value needed to produce the same income, I would have to produce an 11.4% accrual factor in the market net of fees and net of taxes to achieve the same goal.

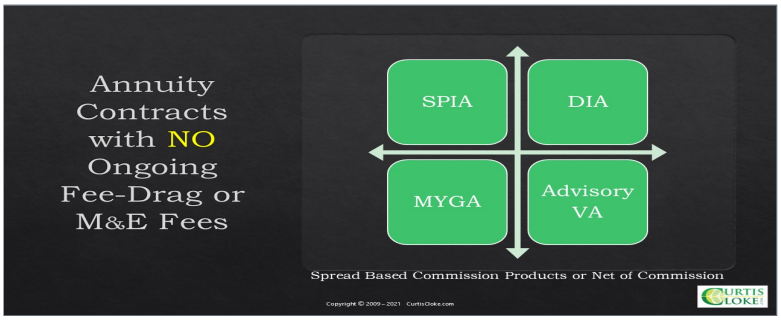
Also, I want you to understand that if I had attempted to do this with bonds, I would have to pay income tax on the phantom income during the deferral period if I delayed with bonds. With the deferred income annuity, it is all tax-deferred. When I get to the income distribution, then I still have income taxes on the portion that is still taxable. With the income annuity, I have an exclusion ratio tax treatment. If I have trading costs and asset management fees for managing the bonds, I have none of those fees with this DIA. And this is with a commission of about two percent already included.

This is relative to the day, but not certainly at the same level. I just wanted to demonstrate the power of this. You still have the no income tax and the deferral. No phantom income tax. You could replicate the laddered idea with zero-coupon bonds, but you would still have the potential cost of trading or buying those bonds. Then you would still have the phantom income tax on the deferral period before the ladders were to mature.

You can create the same income stream with a little bit less capital held hostage to generate the income net of tax and fee drag.

Do All Annuities Have Fees or An Ongoing Fee Drag?

The answer is no – they do not. There are annuity contracts with no ongoing fee drag or M&E fees. They are SPIA, DIA, MYGA, and advisory VA contracts. Advisory VA contracts, the good ones out there, charge a $25 annual administration fee.



You also have spread commission-based products: SPIA, DIA, and MYGA, and you have net-of-commission products. A net-of-commission product is not free; I am not sure an advisor will do the work without charging a fee to give the advice or the service they get to get net-of-commission products. They have to pay to get access to those products. They have to do that with after-tax money. If it is a qualified account, I am paying those baked-in fees in the spread, where I put in this much, and I get this much out already baked in.

Once purchased, there is no ongoing fee drags on any of these except the advisory VA, where there may be a $25 annual administration fee and whatever other fee an advisor puts on there and discloses transparently.

Key Takeaways

In retirement, we all know there are three basic retirement income strategies:

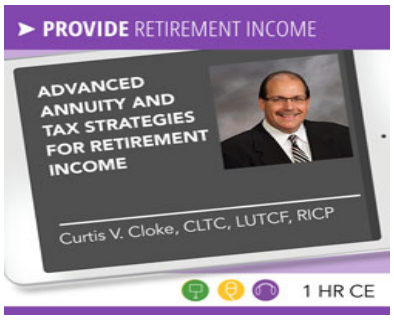
1. Systematic withdrawal income plans.
2. Bucket strategies, with the buckets laddered in progressive time segments of money, and
3. Retirement income floor, or promised-based income floor strategies.

We built our Retirement NextGen software to allow all these to be done dynamically with tax, Medicare Part D, Social Security timing, and Roth conversion strategies. We have tested hundreds and hundreds of case studies. Eighty percent of the case studies we test are more efficient using a hybrid combination of these three approaches together than they are just doing one over the other. So, the power of efficiency is in blending it.

Also, it is the power of not having bias as to specific products, believing more products are superior. Because until we know the facts of the client's situation, the facts of the case, we do not know what is best for the client until we know what the tools do. You would not use a crescent wrench to ratchet a nut off the end of a lug nut for a tire, and we would not use a screwdriver to use in a way that would not be appropriate for a screwdriver. We need to know what the tools do. Use the tools for the right job and collectively understand what these tools might do for the efficiency of tax, fee drag, and inflation.

I want to encourage all of us to think about these. It is just a basket of products. We need to know what the products do without biases. Annuities provide broad-line product types. Annuities may help mitigate tax drag, fee drag, inflation drag with COLAs. Annuities are financial tools that have features and benefits not available by other financial products and vice versa. The basket of products approach blends optimal planning tools that may enhance potentially better outcomes.

The true fiduciary considers and understands all product allocations without bias, no bents. Financial advisors should have no bent for or against annuities. Instead, we should consider them only as one of many financial tools in the toolbox.



Advanced Annuity and Tax Strategies for Retirement Income – Curtis Cloke

About Curtis V. Cloke, CLTC, LUTCF, RICP®, Founder of Thrive Income Distribution System, LLC

Curtis Cloke, CLTC, LUTCF, RICP, is an award-winning financial professional and retirement income expert, trainer, and speaker with three decades of experience in income distribution planning.

Curtis began his career as a financial professional with Prudential Financial. After many successful years with Prudential, he merged with a second firm and then in may of 2014, he founded his own firm, Acuity Financial, Inc. This is where his continues to apply and blend his expertise for his clients by providing advanced retirement income-planning strategies and techniques for financial professionals. Curtis is the developer of the Thrive Income Distribution System®, that provides a contractual solution for inflation-adjusted income utilizing the least amount possible of the client's portfolio value. He has also developed and provided continuing education training to professionals on many topics relating to retirement and estate- planning strategies.

Memberships/Certifications

Curtis is a member of the National Insurance and Financial Advisors Association (NAIFA), and is a former president of the Southeast Iowa Association. He is a member of the Society of Financial Service Professionals (FSP) and is a qualifying member of Top of the Table with the Million Dollar Round Table (MDRT). He has earned his CLTC (Certified in Long Term Care) and LUTCF (Life Underwriters Training Council) designations, and moderates development courses for the Life Underwriters Training Council.

Curtis actively engages all his audiences with his personable character and genuine care for clients' retirement needs and concerns. Through his extensive experience, he has perfected the ability to quickly and accurately identify the income needs of all his clients and he's developed a system-based sales approach that he teaches to advisors. Beyond using annuities to create guaranteed income for life, he shows advisors how to generate the maximum inflation-adjusted income for their clients using the least amount of the portfolio.

With a track record of spot-on media commentary, Curtis Cloke's expertise has been featured in Senior Market Advisor, InsuranceNewsNet, Retirement Income Journal, NAFA Annuity Outlook, The Wealth Channel magazine, LifeHealthPro.com, and many more. He is a frequent guest on radio and TV stations, has appeared as a guest on NAIFA ClientCast by Real Wealth® and as a guest presenter on their webinar series, Power Session LIVE by Real Wealth®. Curtis was recognized in 2009 as a top-five finalist for Advisor of the Year by Senior Market Advisor magazine.

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Incorporating the Housing Asset in Retirement Planning

Shelley Giordano, MA, Enterprise Integration Mutual of Omaha Mortgage, Founder Academy Home Equity Financial Planning

Editor's note: This article is an adaptation of the live webinar delivered by Shelley Giordano in 2021. Her comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2021 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course Incorporating the Housing Asset in Retirement Income Planning for 1.0 hour continuing education (CE) credit.

By Shelley Giordano, MA, Enterprise Integration Mutual of Omaha Mortgage, Founder Academy Home Equity Financial Planning

Dr. Wade Pfau, CFA, RICP notes that there are three significant threats in retirement: longevity, market volatility, and spending shocks. In this article, we are exploring how the housing asset can be utilized to counter these threats.

What Share of Total Wealth Is Represented by The Housing Asset?

The house has come into focus for retirement income planning professionals because it represents such an enormous proportion of the average American's net worth. It is estimated by the US Census Bureau that over 2/3 of the American's net worth, retiree's net worth, is concentrated in their home.

The strategies we will cover here come from the collective wisdom of mathematicians, actuaries, pension lawyers, academicians, and practitioners. Many of them are members of our Academy for Home Equity in Financial Planning, of which Betty Meredith is a member as well. It is not information that is coming to you via a mortgage company. The information you are going to see here has been vetted by the best in your field.

Wealthier clients have the longest life expectancy, so the longevity risk for those people who have many assets and have much social capital are the ones that you need to be looking out for in terms of meeting that longevity challenge.

The Pros and Cons of Reverse Mortgages

Let's start with the things that are not so attractive about a reverse mortgage.

1. It will cost your clients some equity because the product is FHA-insured. There are premiums, both up-front and ongoing, that are going to the Federal Housing Administration (FHA) to provide the safeguards available in reverse mortgages, which we will discuss later. Sometimes, there is quite a sticker shock when your clients see that setting up a reverse mortgage will cost them some of their equity. It is not up-front cash that they need to commit, but depletion of their equity.
2. A reverse mortgage involves compound interest assessment. What that means is because there are no monthly payments. Because the client is not making a payment on the interest, the interest is tacked onto the loan balance, so the loan balance will be larger the following month. The interest is then assessed on that larger loan balance, and so on. The client can make payments on the reverse mortgage, but most people do not do that. So, compound interest is, as we know, just a beautiful thing when it is working for you and not such a beautiful thing when it is working against your equity.

Let's now look at the pros of reverse mortgages.

1. Because of the FHA insurance, the reverse mortgage is a non-recourse loan. That means that the client or their estate will never owe more than the value of the house.
2. Reverse mortgages are incredibly flexible. The client may choose to pay the interest, make payments on the interest and the principal that they have drawn, make no payments, make payments, as Dr. Wade Pfau suggests, in good years. When the market is up, and the retirement assets are healthy, go ahead and make payments, but do not make any payments on your reverse mortgage if they stress the portfolio. Many people do not realize that a reverse mortgage cannot be canceled, frozen, or reduced, and that is even true if it is in a line of credit structure.
3. One of the problems with a HELOC is that just when the client needs liquidity, the banks often cancel and freeze the HELOCs. You cannot be foreclosed on with a reverse mortgage because you have missed a payment, as no payments are required.
4. Credit capacity grows with age.

What is a Home Equity Conversion Reverse Mortgage (HECM)?

A reverse mortgage is a mortgage where the amount of money the client is eligible for is based on the home value. The home provides the dollars, but it also serves as the sole collateral. The client never has to make a payment from any other resources; the house provides the repayment.

Since the loan is non-recourse, actuarial principles apply. The amount of money that the client is eligible for is based on their life expectancy. If the house is going to pay the loan back and you are younger, the assumption is you will be in the house for a longer period, so you will be eligible for less money up front. If you are older, the assumption is you are going to be in the house for a shorter period, so you are eligible for more money. Also, your borrowing power increases as you age because of the actuarial or insurance aspect of a reverse mortgage.

Brian Montgomery, a former FHA commissioner, calls the home equity conversion mortgage the "law of the land." What does that mean? In 1988, President signed a HUD bill (the FHA is the insurance arm of the Department of Housing and Urban Development) and signed the home equity conversion mortgage i

is FHA insured. The bank does not take the house. You are not trading your title and giving it to the bank in return for getting money. You maintain the title to the home.

With reverse mortgages, you cannot owe more than the fair market value of the home. The house is the sole collateral. It is in effect until the last spouse dies, moves, or sells. Many people think that if you use all your money in a reverse mortgage or housing values drop, you will get kicked to the curb by the lender. That cannot happen.

How is a HECM different than a forward mortgage? The homeowner has the option to make monthly payments but is never obligated to make a mortgage payment. There is no prepayment penalty; the loan can be prepaid at the homeowner's will. That is an FHA guarantee. We have seen people who have taken out a reverse mortgage, and then a situation changed rapidly, so they just pay off what they have borrowed, and they can move out of the house. They have not given up title or control of their home.

The FHA non-recourse insurance guarantees that a person or their heirs will never owe more than the home's value, regardless of how long the homeowner lives on the property. It is crucial to be able to understand and articulate this. If using a line of credit arrangement, the unused line of credit grows at the same percentage rate the homeowner is paying on the outstanding loan balance. This rate of growth is not affected by home values. It goes back to that concept that as you age, you get growth in your ability to access your home equity, and it is a predetermined, contractual rate. It is not at the discretion of the lender.

Any unused funds in the line of credit cannot be canceled, frozen, or reduced arbitrarily by the lender. The home must be the primary residence of the borrower. Snowbirds are okay, but the reverse mortgage must be on their primary residence. They must remain current on their property taxes, just like everybody else in America who owns a home. Anyone who has a mortgage also has to be current on their homeowner's insurance, and they have to keep their home in reasonable repair and up-to-date with any HOA fees that might apply.

The reverse mortgage has received a bad reputation because they were provided for people who did not have the willingness and capacity to keep up their homeowner's and tax payments. This was a terrible situation for everybody. We only want to provide reverse mortgages for people when it will improve their retirement security and be sustainable over time.

Dr. Wade Pfau's Four Nevers About Reverse Mortgages

In Dr. Wade Pfau's book on reverse mortgages, he points out the following "Four Nevers" about reverse mortgages:

1. You will never give up title to your home. As I said before, the bank does not get the house.
2. You will never owe more than the home's value. The loan documents state that neither the homeowner nor his estate is ever subject to a deficiency judgment. The corollary is that any remaining equity beyond the loan balance belongs to the borrower or his heirs.

   Let's say that a reverse mortgage loan balance is $400,000. The house is sold for only $300,000, so now there is a $100,000 deficiency or gap. The FHA insurance covers this gap. The corollary is lender does not get a share if the house sells for more than the home's value. Say the house sells for $500,000, and the loan balance is $400,000. That $100,000 remaining equity belongs to the homeowner or their heirs.

   HUD gives the heirs up to 12 months – you need to be in touch with the servicer about this – to sell the house. You need to tell the servicer what your plan is. You are either putting the house up for sale or arranging for your financing to pay off the remaining balance. But again, just remember that it is a non-recourse loan, so if the house's value is not adequate to pay off the mortgage, there is no personal liability to the heirs. They are insured, and they can walk away from the house.
3. The homeowner is never forced to move. Should the available credit be exhausted, the homeowner has the right to remain in the home.
4. There is never a monthly payment required on the principal or the interest until the last borrower leaves the house permanently.

It is also important to note that money accessed via the HECM is considered proceeds from the loan, so those proceeds are not taxed.

Who Qualifies for a Reverse Mortgage?

One of the homeowners needs to be 62 or older. They can have a mortgage.

The No. 1 use of a reverse mortgage is to replace a current mortgage with a reverse mortgage so that the client does not have principal and interest payments to make. Sometimes, it is quite a bit easier to qualify for a reverse mortgage. There is no minimum credit score. Again, it has to be a primary residence. It can be all these different configurations: single-family, condo, duplex, triplex, fourplex, and in some cases, a manufactured home.

HUD especially wants to make sure – and lenders comply, of course, the loan is a suitable and sustainable solution. There is a financial assessment or kind of underwriting to protect against the client eventually going into tax and insurance default.

There are now protections for non-borrowing spouses, so those under the age of 62 have protections to stay in the home should the homeowner die.

There are limitations on accessing the equity. There is a cooling-off period now that encourages the sustainable use of home equity.

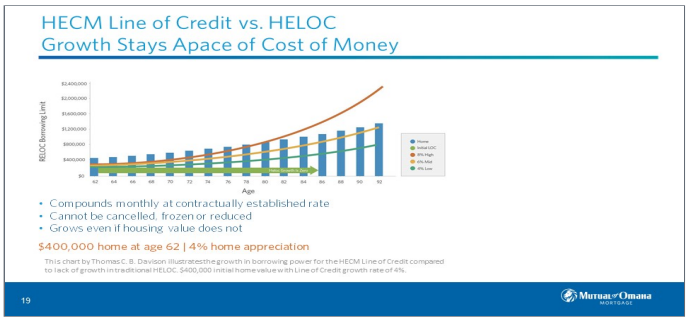
Clients also will need to go through mandatory counseling with an FHA-approved and independent counseling agency. The purpose of this is just to make sure that everybody understands that even though payments are not required, interest is involved. This is a mortgage, and they are responsible for their tax and insurance. Borrowers tend to forget these things.

Differences Between a Traditional HELOC and a HECM Line of Credit

With a HELOC, unless you reapply, you will have a static credit capacity, and it is usually over within ten years. With a HECM line of credit, your borrowing power will grow over time (see orange line below).

Dr. Pfau says, “Opening a HECM line of credit earlier in retirement allows for greater availability of future credit relative to waiting until later in retirement.” You get compounded monthly growth at a contractual rate in your line of credit. Nobody knows what the future holds. You could say, “I will wait ten years,” and then when you go to open your reverse mortgage, the housing values maybe have dropped, or interest rates could be higher, and you would be eligible for less than you would have been eligible for ten years before. A way to ensure that you have access to an increasing value of your home equity is by setting up that line of credit early in retirement.

The example below is of a traditional HELOC where you do not get the automatic growth in the line of credit. The other lines show the HECM line of credit growing at various points. The interest rate is around four percent right now, so the green line provides an example of today’s growth and borrowing capacity from the line of credit.



Three other critical differences are:

1. A HECM is both a mortgage and an actuarial program.
2. The lender does not determine access to equity. HUD does, and it is based on life expectancy.
3. Unlike a traditional mortgage, unless the homeowner takes all available proceeds in a lump sum, they are not locked into an arrangement, and they can make changes as often as they want.

   Let’s say a client has set up a HECM line of credit. They find they are $1,000 short every month between their income and expenses. They can set up a monthly payment for $1,000 for around a $25 fee.

Lump-Sum Options for Dispersing Reverse Mortgage Proceeds

Proceeds can be distributed in various ways:

1. *Lump sum.*
2. *Monthly tenure payment*, which is basically annuitizing what you have available to you. It is a guaranteed payment until the last one of you dies, moves, or sells.
3. *Term payment*. Say you need $12,000 a month so that one of the homeowners can have long-term care or hospice care at home. You can set that up for as long as it will last or as long as needed, whichever comes first.
4. *Reverse mortgage line of credit*. Remember that the lender cannot cancel, reduce, or freeze.

Or you can set these up in a combination. Say you are eligible for $300,000 at the outset and have $100,000 HELOC. You can take a lump sum of $100,000 to pay off the HELOC and put the remaining $200,000 into the line of credit.

What are some ways to use a lump-sum distribution?

1. *Replace a current mortgage with a reverse mortgage*.
2. *Purchase a new home*, which is called a home equity conversion mortgage for purchase.
3. *Establish housing equity in silver divorce.*
4. Use a reverse mortgage on your primary home to purchase another home.

Lump-Sum Example #1: Dr. Pfau has this case study in his book: Mary and John are 65 years old. They have ten years left on their mortgage. Their mortgage payment is $15,574 a year. They will replace their current mortgage with a home equity conversion mortgage, which means they will have no mandatory payments. This establishes cash flow for them of $1,297 per month. The value of their home is $541,000. They owe $129,000, and because of what they were eligible for, they pay off the $129,000, and they still have $99,000 to reserve in their growing line of credit. This line of credit is going to grow in purchasing power as they age.

Lump-Sum Example #2: You can also use a reverse mortgage to purchase a home (HECM for purchase). If you are purchasing a new principal residence, the amount of money you are eligible for will attach to the new home. This is how not to use up all of your assets for a cash purchase or do not want a monthly payment.

For example, a client's wife had died, and he wanted to move to the Bay Area to be near the kids. So, the price of the new house was going to be $700,000. He sold his house for $500,000 and netted $460,000. The advisor knew about the HECM for purchase, and at that time, he was eligible for a $300,000 reverse mortgage on the $700,000 house. He only had to use $400,000 from the sale of his house, allowing him to keep $60,000 from the $460,000 he netted after the sale. No payments are due on the principal or the interest until the last one of them dies, moves, or sells.

Lump-Sum Example #3: Use a reverse mortgage to restore or provide equitable housing for both sides of the divorce transaction. We run into this most often. Mom wants to stay in the house, and the adult children want Mom to stay in the house. Mom will have to take out a mortgage to split the marital assets and pay off the departing husband. This is going to be difficult for her. She is retired, and to take on a mortgage now in order to keep the house and pay off the husband is just not feasible.

A reverse mortgage can be placed on the marital home. The ex-husband gets half of that, and then he takes his half as a down payment on the new house he wants, using a HECM for purchase loan to provide the rest of the financing. Nobody has a monthly payment, and everybody is living in a lovely house.

Another option is that they sell the house, and each of them gets cash. They take the half that they were eligible for and leverage that with a HECM for purchase so that they both can enjoy living in an attractive living environment. This is an elegant solution that advisors do not know very much about, so I encourage you to learn more about this.

Tenure Payment Options for Dispersing Reverse Mortgage Proceeds

Tenure Payment Example #1: One option is to supplement income so Social Security can be deferred or to cover monthly obligations such as insurance products that will help them or raise their spending power.

If there are any longevity expectations, clients need to defer their Social Security until age 70 if possible. In this case study by Tom Davison, CFP, a client retires at age 62 with pretty high living expenses of $87,000 a year. She has $500,000 in her IRA. If she starts drawing on her IRA at age 62, there is a high probability she will quickly exhaust her portfolio. She could use the equity from her home to provide funds from ages 62 to 68 and not draw on her IRA, allowing her to delay taking Social Security until age 70.

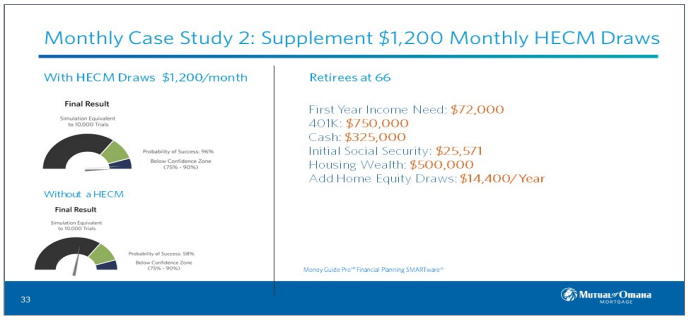
At age 70, she gets a big bump in income from her Social Security at the most significant amount possible. This has an incredible effect on the probability that her portfolio is going to grow. Why did the reverse mortgage – filling the income gap or that bridge – work so well? The reverse mortgage funded six years of spending, so that is six years that she did not have to draw on the portfolio.

Taxes matter. Two-hundred and forty thousand dollars worth of home wealth were added to the $500,000 IRA. The client is in a 33% tax bracket in California combined. Every dollar that she spends of her reverse mortgage has the spending power of $1.50 from her IRA. The $240,000 from the reverse mortgage is the tax equivalent of $360,000 from the IRA.

The investment portfolio was untouched until age 68, so you had six fewer years of withdrawal. When you run a Monte Carlo simulation, it reduced the sequence of returns risk if bad returns hit early in retirement. Also, investment portfolio draws after age 70 were reduced by the largest possible Social Security benefit.

Tenure Example #2: Say a client is interested in supplementing their monthly income with $1,200 monthly HECM draws. It is a very modest amount.

Say a retiree at age 66 has a $72,000 annual income need, a 401(k) of $750,000, a cash bucket of $325,000, an initial annual Social Security income of $25,571, and housing wealth value of $500,000. They are just going to take home equity draws of $14,400 a year.



We modeled the above in Money Guide Pro. Using home equity conversion draws of $1,200 a month, the probability of success is 96%. But without the HECM, without that tax-free bump of $1,200 a month, the probability of success drops substantially.

HECM Line of Credit Client Scenarios

The HECM line of credit (HECM LOC) is a revolving line of credit. If you pay down your loan balance, and your credit available is going to go up.

Also, a HECM line of credit grows and compound at a contractually determined rate as the client ages. Let's say you have a $100,000 HECM LOC. At the end of the first year, it will grow to $104,000, and then that will compound. Next year's growth is based on the growth from the first year.

There are three ways a HECM Line of Credit can be used in retirement:

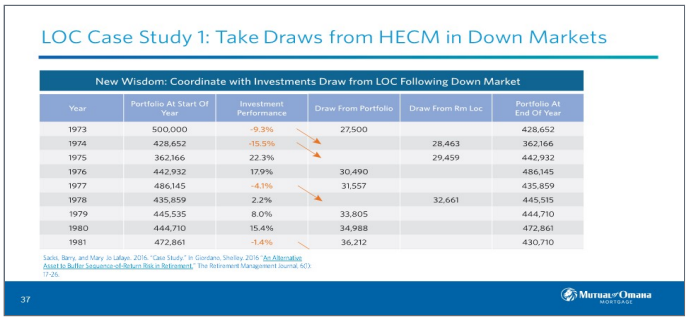
1. Mitigate sequence of returns risk
2. Self-insure for long term care, or

3. Used as a shock absorber for unexpected events.

HECM Line of Credit Example #1: Dr. Barry Sacks was the first to identify that if you just take draws from your portfolio following growth years and not take draws in years when the portfolio has shrunk, it could have a fantastic effect on the longevity of the portfolio over time, particularly if you had bad investing results early in retirement.

Assume a client has a $500,000 portfolio, and the client draws $27,500 from his portfolio in year one (see below). Following Dr. Sacks' strategy, during that year, since there was a negative return, the client will draw from his HECM line of credit instead.

Then there is a second negative year. The client again draws from his HECM line of credit to protect the portfolio. In year three, there is a positive performance year, so the client draws from his portfolio. When portfolio returns are positive, draw from the portfolio; when negative, draw from the HECM line of credit. Notice that four of the first nine years are negative, so this is a case with an adverse early sequence of returns.



LOC Case Study 1: Take Draws from HECM in Down Markets

New Wisdom: Coordinate with Investments Draw from LOC Following Down Market

Year	Portfolio At Start Of Year	Investment Performance	Draw From Portfolio	Draw From Rm Loc	Portfolio At End Of Year
1973	500,000	-9.3%	27,500		428,652
1974	428,652	-15.5%		28,463	362,166
1975	362,166	22.3%		29,459	442,932
1976	442,932	17.9%	30,490		486,145
1977	486,145	-4.1%	31,557		435,859
1978	435,859	2.2%		32,661	445,515
1979	445,535	8.0%	33,805		444,710
1980	444,710	15.4%	34,988		472,861
1981	472,861	-1.4%	36,212		430,710

Sacks, Barry, and Mary Jo Lafaye. 2016. "Case Study" in Giordano, Shelley 2016 "An Alternative Asset to Buffer Sequence-of-Return Risk in Retirement." The Retirement Management Journal, 4(1): 17-26.

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Mutual of Omaha MORTGAGE

In the chart below, you see the client eventually runs out of money in the portfolio, so they have to wait and pray. They must hope there is a reverse mortgage around that will provide them spending dollars. At this point, they are relying on their reverse mortgage as a last resort, which is the worst possible strategy.

In the column at the far right, you can see that the protective effect on the client's portfolio by utilizing the strategy above is just astounding. They end up with twice as much in the portfolio as when they started. There is debt on the house because they allowed the interest on what they borrowed to compound over 30 years. They could have paid this down or just paid the interest, but they did not, so they had $692,000 worth of debt on the home. Remember, if the house is only worth $500,000, they do not owe that back, and they still have $1 million in their portfolio. Even in this situation, they are ahead $394,000 versus the $538,000 in the negative.

LOC : Avoiding Spending in Bear Markets

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Mutual of Omaha MORTGAGE

HECM Line of Credit Example #2: This growing line of credit is kind of a "put" on long-term care.

For clients who cannot be underwritten for long-term care or just reject the idea of buying long-term care insurance, an option is to provide self-insurance with the reverse mortgage line of credit.

Say a client age 66 has a home value of $400,000 and cannot qualify for long-term care insurance. Their initial line of credit is $194,000. After five years, the line of credit is $237,000. After ten years, the line of credit is $291,071. The HECM line of credit is an asset they can deploy and be ready if they have a long-term care expense.

HECM Line of Credit Example #3: The HECM line of credit can be used as a shock absorber to plan for the unexpected. How do you plan for unexpected spending shocks? We have had people leave the closing table, walk across the street to their dentist, and spend $10,000, $20,000 on dental work.

Car repairs and transportation are also costly as people age. Housing value shock, health shocks, liquidity shock, inflation shock, divorce shock, and portfolio shock. Who does not need a backup in retirement? What is your backup if you are thinking proactively? It is to have your clients start thinking about their house as an asset and put a reverse mortgage on it early, whether they use it or not.

Key Takeaways

The question then becomes: *Can you justify ignoring a client's major asset?* Jamie Hopkins Esq., LLM, CFP®, ChFC®, CLU®, RICP®, Managing Director of Carson Group Coaching says, "The lack of focus on home equity in retirement income planning is nothing short of a complete failure to properly plan and utilize all available retirement assets. This needs to change immediately because strategic uses of home equity, especially reverse mortgages, can save many people from financial failure in retirement and help stem the overall retirement income crisis facing Americans."

Many of you have broker-dealer sanctions against discussing reverse mortgages. If you would like to get the conversation going, the Academy of Home Equity in Financial Planning at the University of Illinois has published model language that some broker-dealers are using to make sure everybody is compliant with using home equity. 81% of Americans over age 65 own a home. It is there. You do not have to create it.

Key actions to take with clients and reverse mortgages:

1. Differentiate your practice by providing advice on America's No. 1 asset.
2. Prepare your clients early for market turbulence, have it ready to go.
3. Guarantee access to home equity throughout the retirement years. You do not know what the future holds. You do not know what home values are. You do not know what interest rates are. You do not know if reverse mortgages will even exist in 20 years. But if you set up a home equity conversion mortgage now, access to home equity is guaranteed by the full faith and credit of the US Government.
4. Assist clients in financing a preferred home for retirement. Help them make that move.
5. Suggest novel solutions to restore equity in housing at divorce. Everybody needs to know that who is in the financial services advice arena.
6. Provide bridge income in Social Security deferral. We have to have people deferring their Social Security.
7. Improve liquidity throughout retirement. You cannot guarantee – the banks are not necessarily going to be your friend when they are having liquidity issues.
8. Focus on preserving cash assets for longevity and the estate. Protect that portfolio with another asset, coordinate, integrate all your assets.
9. A reverse mortgage can be used to self-fund for long-term care needs.

Incorporating the Housing Asset in Retirement Income Planning – Shelley Giordano

About Shelley Giordano, MA, Enterprise Integration Mutual of Omaha Mortgage, Founder Academy Home Equity Financial Planning

Shelley's background in reverse mortgage lending is diverse and includes origination, sales management, and industry leadership. She read a very early article article written by Barry Sacks, PhD, JD , in 2005, and since then have advocated for the protective power of housing wealth in the retirement distribution phase.

Shelley supports the conservative, proactive use of housing wealth. She also promotes responsible lending principles.

As head of Mutual of Omaha Mortgage's Enterprise Integration and Founder of the Academy Home Equity Financial Planning University of Illinois, she strives for collaboration among thought leaders in academia, regulatory agencies and financial services firms that are investigating the proper role of housing wealth in retirement.

Shelley strives for the right of the American retiree to have access to accurate information on how reverse mortgage lending works, and how much it costs. Her years in the industry have proven that product innovation is not necessarily in the best long-term interests of the consumer or the taxpayer. Because the US Government is the ultimate backstop for the HECM, she does not support product innovation at the expense of the taxpayer. Most importantly, Shelley is devoted to helping retirees, especially Baby Boomers, understand that housing wealth may contribute to a financially secure retirement.

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Advanced Strategies for Using Housing Wealth to Improve Financial Outcomes in Retirement

Barry Sacks, PhD, JD

Editor's note: This article is an adaptation of the live webinar delivered by Barry Sacks in 2021. His comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2021 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)
You may also choose to take the full length course Advanced Strategies for Using Housing Wealth to Improve Financial Outcomes in Retirement for 1.0 hour continuing education (CE) credit.

By Barry Sacks, PhD, JD

In this article, we will cover some advanced strategies that use housing wealth to improve financial outcomes in retirement. So, what's meant by improving financial outcomes in this context? A significant concern of retirees and their financial planners is the risk of these retirees outliving their financial resources, which is more colloquially referred to as running out of money. There is nothing worse than running out of money, especially when one is in advanced age, and there is no way of recovering.

To improve financial outcomes means to reduce the risk of cashflow exhaustion of running out of money.

Protecting a Securities Portfolio from Sequence of Returns Risk

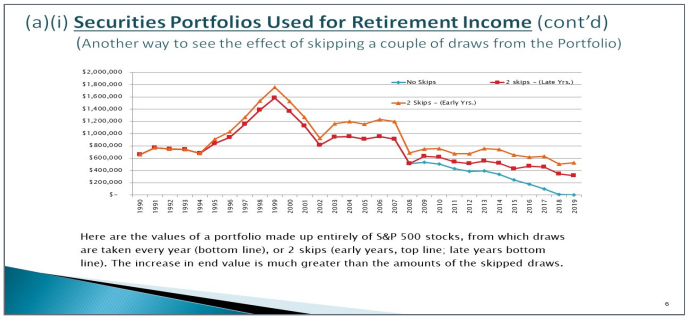
Typically, people who retire and who have been foresighted enough to put away money in a 401K plan or some other savings vehicle hold that money in the form of a securities portfolio. One of the things that happen with any securities portfolio is volatility, which can lead to difficulty when drawing on a portfolio.

As soon as you start to take money out of a portfolio, it becomes essential to look at the sequence of returns, particularly when weak or negative returns occur. There are going to be adverse events in the early years. There's going to be some in the late years.

Let's consider a very simple example to illustrate. Think about a portfolio with a value of $100, or as many more zeroes after that as you'd like, because this entire concept scales irrespective of the size. Suppose in that first year, the portfolio loses 20 percent, so at the end of that year, it's worth $80. Again, there are as many zeroes after it as are necessary. If no draw is taken, it will require a 25 percent gain in the next year or even a series of years to return to its original value of $100. If, on the other hand, a $5 draw is taken at the end of the first year after that 20 percent loss, it leaves an end value of $75.

Therefore, it would require a 33 percent gain in the next year or next few years to return to its original value of $100. The point is that taking any money from a portfolio that has gone down makes it that much harder for the portfolio to recover. If there is a series of these, it can lead to the portfolio becoming exhausted prematurely. In fact, that's what led to the famous four percent rule because, on average, a portfolio does much better than four percent. Because there are downturns and the four percent rule was developed in the concept of drawing money from the portfolio every single year, whether there were upturns or downturns, the amount was always the same adjusted only for inflation.

Now, let's look at a more complicated example. Here's an example of a $750,000 portfolio invested in the S&P 500 over the 30 years from 1990 to 2019.



The lowest line of the three lines represents no skipping of draws. Every year, the same amount of money (6% of the portfolio's value) was taken, adjusted only for inflation. Notice that by 2018, which is before the end of the 30-year retirement, it had run out of money.

The top line shows that if we skip two draws, particularly in the early years, at the end of 30 years, there is nearly $600,000. The middle red line shows that if we skipped two draws in the later years, there is a remaining value at the end of 2019 of about $300,000.

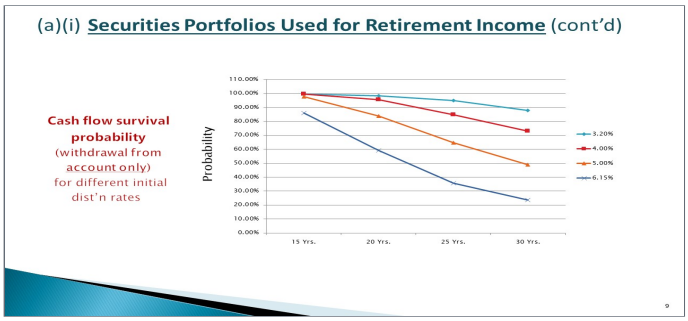
Now, the point is, of course, that if somebody is retired and they skip one of the annual draws from the portfolio, they've got to live on something. What do they live on? Well, as it happens, the title of this article is housing wealth. And if you take a draw from a reverse mortgage credit line then, what will happen is that you've got the money to live on, and you let the portfolio recover. The amount of money left in the portfolio grows at the portfolio rate, in contrast to the cost of drawing on a reverse mortgage credit line is an interest rate, which is lower over time than the value of the portfolio's growth.

The famous four percent SafeMax rule was developed by William Bengen back in 1994. It covered a whole raft of 30-year periods using actual portfolios, un
example that I just gave with a pure stock portfolio invested in the S&P 500. Bengen used various mixed portfolios from about 40 percent stock/60 percent

up to about 70 percent stocks and 30 percent bonds. He found that if you drew four percent initially and then adjusted that draw for inflation over all of the subsequent years, that the portfolio didn't run out of money.

Suppose we do mathematical modeling with a Monte Carlo simulation using today's projected investment returns. In this case, we find that to achieve a 90 percent probability of success, you can only take a 3.2 percent withdrawal to be absolutely safe when drawing exclusively from the portfolio. That's the point. If you draw exclusively from the portfolio, you've subjected yourself to the sequence of returns risk because you're withdrawing even when the portfolio is down. That leads to cashflow exhaustion or at least enhances the probability of cashflow exhaustion.

Suppose you take an unsafe approach, meaning increasing with today's projections from 3.2 percent to 4 percent or from 4 percent to 5 percent using Bengen's data. In that case, you find that you increase the probability of cash flow exhaustion in fewer than 30 years from 10 percent up to 30 percent. Below depicts what happens if you're taking cash flow at various initial percentages and after that doing nothing but inflation adjustment.



So, whether the portfolio goes up a lot, up a little, down a lot, down a little, you're only adjusting the cash flow for inflation. And the reason for thinking that way is that it's for constant purchasing power. The top blue line after 30 years has a probability of about 90 percent success. That means that cash will flow at a constant purchasing power in 90 percent of the scenarios, which means a 90 percent probability. If, however, you increase the cash flow to four percent of the portfolio – that is, the initial draw and then adjust that for inflation – then you're down to about just a little above 70 percent of the probability of cash flow survival for 30 years. At 6.15 percent, we're down to about a 1 in 4 probability of cash flow survival.

That's a terrible way to retire, risking that you'll run out of money three times out of four.

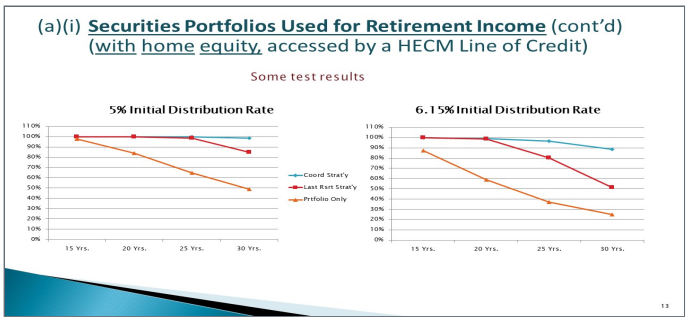
The conventional wisdom for dealing with the risk of that exhaustion is when the portfolio is exhausted, use home equity. Use a reverse mortgage as a last resort. It's what I call a wait-and-see approach. Because after all, if you've got a one out of four chance of making it, maybe you don't want to take the risk of digging into the house equity.

A better strategy might be an active strategy or a coordinated strategy that enables the retiree to avoid drawing on the portfolio when it's had negative or weak investment performance, especially in the early years of retirement. One way to do that is to draw instead on a reverse mortgage credit line each time the portfolio's investment performance was negative or weak. I published an article in 2012 and another article in 2017 with more variation testing this strategy.

We ran two spreadsheets simultaneously that are identical in every respect, except the timing of the draw on the portfolio or the reverse mortgage or HECM credit line (home equity conversion mortgage). It's the most widespread, most widely used kind of reverse mortgage. We used a portfolio value equal to $750,000, which is also the initial home value. The composition of that portfolio is 60 percent stocks and 40 percent bonds because that tends to be a bit more stable and more widely used.

We found that if we use a coordinated strategy and a five percent initial distribution rate adjusted annually for inflation, there is a one hundred percent likelihood that the portfolio will last (blue line on top) even after thirty years of distributions.

In the graph on the right, if we go up to a 6.15 percent distribution rate, there is a ninety percent probability that a coordinated portfolio and the home equity strategy continue to provide as much cash flow and constant purchasing power as which we started. If we use the last resort strategy, there is a 50/50 chance of success. And if the portfolio alone is drawn upon, even with this kind of portfolio at a 6.15 percent initial distribution rate, we only have roughly a 1 out of 4 chance of the cash flow making it.



Obviously, there's a tremendous advantage in using the coordinated strategy. Moreover, there is a tremendous increase in the amount of cash flow. It's twice as much as the 3.2 percent rate if you're drawing on the portfolio only.

To recap: Where the initial home value is close to the initial portfolio, that's the one-to-one ratio, and the coordinated strategy is used, an initial draw rate of s of the portfolio value will provide about a 90 percent probability of cash flow survival. That's a terrific result. That's twice as much as the portfolio alone in today's

returns environment. Other initial draw rates can also provide a 90 percent probability of success with other home-to-portfolio value ratios.

The most important thing, especially for financial planners and their clients, is don't think of it as set it and forget it. If appropriate, be prepared to adjust spending levels. It's easier to make minor adjustments early than major revisions later.

Replacing a Conventional Mortgage to End Mortgage Payments

Let's now look at someone who retires with a mortgage balance on a conventional mortgage. About 30 percent of people who retire owning a home do so with a mortgage, which is a significant portion of many people's income.

Let's say a retiree retires with a remaining mortgage balance of $200,000 on a home worth $700,000 and 15 years to go, or 180 months of payments. Let's assume payments are $1,568 a month. Over 180 months, these total to more than a quarter of a million dollars, or $282,000. A retiree can use a reverse mortgage to refinance an existing debt into a non-recourse loan with deferred payment.

A typical retiree in their late 60's can get a reverse mortgage in the amount of about a 45 to 55 percent range of the house's value depending on age. This retiree then qualifies to refinance their existing $200,000 mortgage into a HECM with available proceeds of about $350,000.

If the existing $200,000 conventional mortgage is refinanced into a HECM, it eliminates the monthly payment obligation. That's already a terrific help to cashflow drain. Then, it provides access to an additional HECM line of credit of $150,000, which can be used to manage the sequence of returns risk throughout the distribution phase of retirement. Obviously, in this case, where $200,000 of the $350,000 is already used up in making a loan payoff, the advantage that's available to help deal with the securities portfolio is far less, but it's not absent.

If the reverse mortgage is the remainder of the original purchased mortgage or a refinancing, then that portion of the reverse mortgage is considered acquisition indebtedness. Any indebtedness secured by the home that is not acquisition indebtedness is called home equity indebtedness. Under the 2017 tax law, interest on home equity indebtedness is no longer deductible. Interest on acquisition indebtedness is still deductible to a lesser extent than before but still deductible.

In other words, you don't lose the acquisition indebtedness character of the conventional mortgage if it had such character by refinancing it into either another conventional mortgage or a reverse mortgage. In this case, the interest that accrues on that portion of the loan is deductible when paid. Generally, it's deductible when paid if there aren't other complications involved.

The other portion of the reverse mortgage, that is the $150,000 portion reserved as a line of credit, creates home equity indebtedness. Under the 2017 tax law, the interest on that indebtedness won't be deductible.

Downsizing to Eliminate Debt and Increase Income-Producing Investments

Let's say Joe is 70 years old. Joe's wife passed away a few years after they refinanced their home. The debt on the home is now $400,000. Upon the passing of Joe's wife, the household income diminished by $1,200 a month, making the monthly mortgage payment difficult. Joe is going to downsize and sell his home worth $950,000. After real estate commission, he will net $893,000 and pay off the $400,000 existing mortgage, ending his mortgage payments of $2,350 a month. Think of the savings in cash flow!

Joe buys a new home for $625,000. He makes a down payment of $275,000, and he gets what's called HECM for purchase reverse mortgage to finance the rest. A HECM for purchase is a reverse mortgage that you can use to facilitate purchasing a new home. This leaves $218,000 of the cash remaining from the sale of his home to invest or for home improvement, and his $2,350 monthly mortgage payments are wiped out.

Assume he generates a five percent return on the $218,000 or about $900 a month in income. This means a net monthly increase in cash flow of about $3,200, or $39,000 a year. That's a fantastic improvement, and it's because he was able to downsize and use a HECM for purchase reverse mortgage.

Let's look at the tax issues here. In this case, if the home is sold after substantial appreciation, there is capital gain. If the seller is a couple, which is not Joe's case, the capital gain exclusion is $500,000. If the seller is a single individual, the capital gain exclusion is $250,000. So, that's important to note because it was, in our example, a $900,000 house. There was likely quite a bit of capital gain. But only a portion of it is subject to capital gain tax because you get a $250,000 exclusion. Moreover, the capital gain rate is lower than the ordinary income rate. He may have to pay some tax, but it's not likely to be a big hit.

The reverse mortgage loan that pays the portion of the purchase price is acquisition indebtedness. The accrued interest on the acquisition indebtedness will be deductible when paid.

Using a Reverse Mortgage with Silver Divorce

There are many scenarios in which a reverse mortgage can facilitate asset division in silver or gray divorce. People over age 50 are the only cohort that continues to experience an increased rate of divorce. Younger people seem not to be divorcing as much or at least not increasing the rate of divorce.

I published the following illustration in the *Journal of the Society for Divorce Financial Analysts*. Luke and Laura are divorcing, and they own the home free and clear. Laura wants to keep the home. From the home, each party is entitled to $350,000. They want to follow a scenario that does not require them to come up with a whole bunch of cash, so Laura obtains a HECM refinance in the amount of $350,000 to purchase Luke's interest.

All the mortgage payments are deferred until Laura permanently vacates the home, so it doesn't impact her cash flow. Luke receives the $350,000 and uses that as a down payment using a HECM for purchase for a new home. His new home will cost $635,000, so his down payment is $285,000, and the HECM for purchas remaining $350,000.

This leaves him $65,000 remaining for future income or home improvement. The result is that both parties remain homeowners, and neither party incurs a monthly mortgage payment obligation. Neither party has to draw on any income-producing assets, so they don't get hit with the tax if they drew the money from a 401K account or a rollover IRA. There is no capital gain tax or sales fees incurred. And Luke increased the value of his investment portfolio or has extra money for home improvement.

Why is there no capital gain tax? Let's assume that house was purchased for a whole lot less. Now, one-half of it is purchased by one of the parties, Laura, from Luke. In the Internal Revenue Code, there is a special exception for situations between spouses in several situations, particularly in the context of divorce. One would suspect that Luke might be hit with a capital gain tax. But because of the special exemption in the code, there is no tax.

Additional Tax Strategies with Reverse Mortgages

The interest accrues on a reverse mortgage debt for many years. As we all know, it's not deductible until actually paid. That's because most borrowers are cash method taxpayers. It's often the case that reverse mortgage debt is paid following the homeowner's death who is the borrower. Sometimes, the homeowner borrower leaves the home permanently while still living, and the reverse mortgage debt is then paid. So, we've got two situations to consider. Leaving home horizontally, which means following death, or vertically, which means going somewhere else.

Let's point out some critical values. Over the typical 10-to-25-year duration of a reverse mortgage, the amount of accrued interest allowable as a deduction can be in the tens of thousands to hundreds of thousands of dollars. It really does build up. The rules that determine the amount of interest allowable as a deduction depend on whether the reverse mortgage loan itself is properly characterized as acquisition indebtedness or as home equity indebtedness.

If the coordinated strategy is used and people are reasonably careful during their retirement years, there is likely to be ample income available against which to use the deduction. So, when they pay off the debt, that's when the income deduction is taken. The deduction for accrued interest on acquisition indebtedness can be used against any income to the extent allowable.

If the homeowner borrower does not have enough other income to be offset by that deduction but does have a 401(k) account or a rollover IRA, they can take a distribution which would be then entirely tax-free. It warms the heart of a tax lawyer to think that the money in question has never been taxed and never will be taxed because the reverse mortgage interest creates the deduction that makes that money deductible when it went into the 401(k). The earnings in it were tax-exempt because it's a tax-exempt entity. And when coming out, the income that would be taxable is offset by the deduction for the interest that accrued. Then, we have a complete legal avoidance of the tax.

If not taking out the money, they can do a Roth conversion. That can make tax-deferred money never taxable. It's a terrific thing to keep in mind when the interest is deductible, which means that the interest is based on acquisition indebtedness. An important point to note, though, is that the distribution or Roth conversion must be accomplished in the same year that the interest is paid off because the deduction cannot be carried forward or backward like business operating loss.

The above strategy is for when the borrower leaves the home permanently while still living. Now, we'll go to the situation where the borrower dies, and the interest is then paid off by the heirs using IRS regulation, 1.691B-1, which allows what's called a "deduction in respect of a decedent." The idea is, typically, the estate doesn't have enough earnings to benefit from the deduction. Following the language of this regulation, to pass the home to the adult child(ren) or the beneficiaries of the 401(k) account or the rollover IRA because then they can sell the house, pay off the mortgage, and with that payoff is the interest deduction. The interest deduction, of course, is the offset against what they have as income.

Key Takeaways

We've shown the effect of skipping a few distributions from a securities portfolio and replacing the income withdraws on a buffer asset such as home equity. Cash-value life insurance can also be used in this context. It's important to remember that skipping a few distributions from a securities portfolio early on can make the portfolio last a whole lot longer because the amount that stays in the portfolio grows at the portfolio rate. The cost of replacing it with draws from a reverse mortgage line of credit, or the cost of borrowing, is an interest rate. The interest rate tends to be less in the long run than the growth rate of a balanced portfolio.

The second item we looked at was replacing a conventional mortgage. Using a reverse mortgage to replace a conventional mortgage substantially reduces cash flow needs during retirement, particularly for retirees who want to age in place.

We've also shown how to downsize or change location using a reverse mortgage for purchase can reduce cash outflow and provide additional funds to invest for additional cash inflow in retirement.

And finally, we've shown that using a reverse mortgage can provide liquidity for the division of assets in a silver divorce. The result is that less cash is needed for housing than without the reverse mortgage.

About Barry Sacks, PhD, JD

Barry Sacks, Ph.D. earned his Ph.D. in semi-conductor physics from M.I.T., and then taught at U.C. Berkeley. He earned a J.D. Harvard Law School, and is a Certified Specialist, Taxation Law, from the California Board of Legal Specialization. Barry spent 35 years as an ERISA attorney, specializing in qualified retirement plans. He then used his breadth of skills to discover a role for a reverse mortgage to help make a retirement portfolio last longer. Barry now has a law practice providing special services to tax professionals in the area of "Offers in Compromise" for retirees living on 401(k) accounts or other securities portfolios.

Advanced Strategies for Using Housing Wealth to Improve Financial Outcomes in Retirement – Barry Sacks

Barry and his brother, Stephen Sacks, Ph.D. shared their analysis of the reverse mortgage credit line in the February, 2012 Journal of Financial Planning. They revealed that if a reverse mortgage credit line was drawn on before drawing on investments when values had declined, a retiree's residual net worth (portfolio plus home equity) after 30 years is about twice as likely to be greater than using home equity as a last resort. Evensky, Salter and Pfieffer then published their paper in the Journal of Financial Planning the following year on how to increase the sustainable withdrawal rate using the reverse mortgage line of credit.

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