Estate & Income Tax Planning – The Forgotten Strategy of a Reverse Mortgage & Roth Conversion

Home prices have recently reached historic highs in the United States with the median home sales price increasing to over $400,000.00. Many homes have over $1,000,000 of equity built up over the years. This provides for excellent opportunity to consider using the home equity to provide the funds necessary to pay the income tax bite on a Roth Conversion.

The hot topic in income tax and estate planning is converting traditional IRAs to Roth IRAs. When this occurs, the IRA is income taxed at the time of the conversion at the IRA owner's ordinary income tax rate. Typically, the income tax is paid out of the traditional IRA funds reducing the benefit of the Roth Conversion.

David Garrison and I have been discussing over the last number of months using a taxpayer's home equity to pay the income taxes on the Roth Conversion. Here is how it works:

The Taxpayer converts $1,000,000 Traditional IRA to a Roth IRA. On the conversion, the taxpayer is going to incur approximately $400,000 of income taxes depending on his or her state (this perhaps can be reduced by staging the Roth Conversion over a number of years).

The benefits of a Roth Conversion are:

- Invested funds in a Roth IRA are not subject to Required Minimum Distributions ("RMDs")
- Funds can be withdrawn tax-free during life or after death, which is a significant benefit if you want to combine your Roth IRAs on your death with protection planning using trusts for the benefit of your children
- Funds in a Roth IRA grow tax free until 10 years after the death of the Owner (subject to certain other complex rules that require small RMDs after Roth IRA owner's death if death occurs after age 72, and the shorting of the 10-year period if death occurs in the owner's 80s)

The downside of the above strategy is how is the taxpayer going to pay the income tax without selling capital gain assets such as stocks in an investment account causing additional income taxes or depleting the converted Traditional IRA funds reducing the benefits of the Roth Conversion.

An alternative that everyone should explore is using a HECM (Home Equity Conversion Mortgage, also know as a reverse mortgage). The HECM depending on the age of the owners of the home and equity available in the home may provide the funds necessary to pay of the income taxes on the Roth Conversion without causing additional income taxes. Additionally, a HECM requires no monthly principal and interest payments which provides for maximum efficiency of the Roth Conversion strategy. This is a strategy that everyone should be considering when contemplating a Roth Conversion.

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Brian A. Eagle, managing partner of the law firm of Eagle & Fein, P.C. is celebrating 30 years of serving clients. Brian inspires families to plan to meet their goals and objectives based on a unique process that focuses on the definition of proper planning.

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