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Rev. Rul. 80-248

ISSUES

When is interest on a "reverse mortgage loan" includible in the gross income of a lender and deductible by a borrower under the circumstances described below?

FACTS

A state permits various kinds of lending institutions located within the state to make reverse mortgage loans to individuals who own their own homes, which they occupy as their principal residence. A reverse mortgage loan is secured by a mortgage on the borrower's principal residence. A reverse mortgage loan is one in which the lending institution commits itself to a principal amount, not to exceed 80 percent of the appraised value of the property, which is paid to the borrower in installments over a period of months or years. Repayment of the loan is due when the principal amount has been fully paid to the borrower, the residence that secures the loan is sold, the borrower dies, or the borrower ceases to use the home as the borrower's principal residence. The loan agreement may provide that interest will be added to the outstanding <Page 165> loan balance monthly as it accrues. The outstanding loan balance is the current amount of money owed by the borrower to the lending institution and includes the total of the installments paid by the lender to date, the total accrued interest if any to date, and any other charges, such as taxes and insurance, paid to date by the lender upon the borrower's failure to make such payment. The primary purpose of the reverse mortgage loan is to enable elderly persons with limited incomes to remain in their homes.

A lending institution made a reverse mortgage loan to an individual who qualified for such a loan. The loan agreement provides that interest will be added to the outstanding loan balance monthly as it accrues. Both the lender and the borrower use the cash receipts and disbursements method of accounting.

LAW AND ANALYSIS

(1) Section 451 of the Internal Revenue Code provides that the amount of any item of gross income is includible in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Section 1.451-(a) of the Income Tax Regulations provides that income is includible in gross income for the taxable year in which it is actually or constructively received by the taxpayer, unless it is includible in a different year in accordance with the taxpayer's method of accounting. Section 1.451-2(a) of the regulations provides that income although not actually reduced to a taxpayer's possession is constructively received by the taxpayer in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of

intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.In this case, the loan agreement provides that interest will be added to the outstanding loan balance monthly as it accrues. However, this interest is not received by the bank, nor is it available to be drawn upon by the bank. Therefore, the bank is not in actual or constructive receipt of the interest when it is added to the outstanding loan balance.

(2) Section 163(a) of the Code allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Section 461(a) of the Code provides that the amount of any allowable deduction shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. Section 1.461-1(a)(1) of the regulations provides that, under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid.If a taxpayer who uses the cash receipts and disbursement method of acounting owes interest on an obligation and gives a note to the creditor to cover the interest, the taxpayer has not paid the interest for federal income tax purposes. The payment occurs when the taxpayer pays the interest in cash or by transferring property. See McAdams v. Commissioner,15 T.C. 231 (1950), aff'd 198 F.2d 54 (5th Cir. 1952); Bramer v. Commissioner,6 T.C. 1027 (1946), aff'd 161 F.2d 185 (3rd Cir. 1947). See also Rev. Rul. 76-135, 1976-1 C.B. 114, which states that actual payments of cash are required as a basis for any deductions allowable to a taxpayer who uses the cash receipts and disbursements method of accounting.

HOLDINGS

The interest is includible in the lender's gross income when it is actually or constructively received by the lender and is deductible by the borrower when it is actually paid by the borrower. Actual or constructive receipt or payment does not occur when the interest is added to the outstanding loan balance. Therefore, the interest is neither includible in the lender's gross income nor deductible by the borrower at that time.