

Unlocking Tax Benefits with Reverse Mortgages

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Housing wealth expert Don Graves explains how leveraging home equity through a reverse mortgage can create tax-free income streams and protect retirement assets.

Robert Powell: How might you use a reverse mortgage to manage taxes in retirement? Here to talk with me about that is Don Graves. He's the president of the Housing Wealth Institute, the author of three books on reverse mortgages, and an adjunct instructor of retirement income at the American College of Financial Services. Don, welcome.

Don Graves: Thank you, Bob Powell. Good to be back with you.

Powell: It's good to have you here. I understand that you've written an article for Retirement Daily where you describe the seven ways that you can reduce taxes by using a reverse mortgage. Walk us through it.

Graves: That's crazy, isn't it? Just think about that. You mention reverse mortgage at the barbecue and you know what happens, Bob? Three people dive under the table. It's dangerous. To think about using a reverse mortgage to manage taxes in retirement—that's got to be unheard of or at least unorthodox. But that's one of the things, Bob, that your platform allows people like myself and the reverse mortgage to overflow into larger applications. I appreciate that.

I met you through one of your organizations that specifically works with advisors on how to manage taxes and IRAs. Apparently, and you can chime in on this, most of the retirement wealth in America is being held in tax-deferred accounts. Is that correct?

Powell: Yes, and many people refer to it as a ticking tax bomb. So it's a problem.

Tax Challenges in Retirement

Graves: Folks within your organization are consistently saying and proving that taxes have nowhere to go but up. We hope that's not going to be true, but it looks like it could be, unless we slash all this money we're spending these days. But prevailing wisdom is we've dug ourselves a pretty big hole.

In retirement, there are typically four key tax issues you're looking at: required minimum distributions, capital gains tax, Social Security taxes, and the income-related monthly adjustment amount (IRMAA) surcharges that not a lot of people know about. You need strategies to deal with the taxes that are coming on your tax-deferred accounts.

Powell: So how does someone put a reverse mortgage in use? Why is it so unique?

Understanding Reverse Mortgages

Graves: A reverse mortgage, by way of quick definition, is a federally insured loan for those age 62 or better. There are some proprietary products as well, but the most common is the home equity conversion mortgage. It allows retirees to borrow money without giving up ownership or coming off title, and they don't have to make a monthly mortgage repayment.

The most common use of the home equity conversion mortgage is the line of credit. A 65-year-old in an \$800,000 home is able to get around \$236,000 in a growing line of credit. The reverse mortgage line of credit is a growing line of credit. As you leave it in there, it's just growing. And that's going to become the foundation for all of these seven strategies we'll talk about—the growing line of credit.

Powell: So there are seven steps that you go through in the article. Is it worth going through them now?

Seven Tax-Saving Strategies

Graves: I think so. I can do them quickly, then people can read the article.

1. Supplementing Income Beyond RMDs

Required minimum distributions are going to kick in at 73 or at some point, I think 75. All that money in your tax-deferred accounts, Uncle Sam says you need to start taking it and you need to start paying us. But we don't know what Sam is going to require.

What happens if you say, "Don, I know I have to take my required minimum distributions, but I need a little bit more than the RMDs." I would say, if you can limit your RMDs to just that and anything extra, take it from some other non-taxable account, if you have one.

That's where the reverse mortgage line of credit comes in. Take your RMDs, but anything above that or beyond RMDs, take it from your reverse mortgage. That's going to mitigate the taxes because that's less taxes you're going to have to pay.

2. Delaying Social Security Benefits

We've heard that for many people, if you can defer your Social Security from age 62 to 67 or 70, it's going to grow at around 8%. Not everybody can do that, but some people can, and it's going to be beneficial to many.

But here's what happens: "Don, I'd like to defer Social Security. We're in the process of deferring it so we can make that check as big as possible, but we need some money now. I don't want to turn on the Social Security because we have a strategy, but I need money."

So they say, "I'm going to go into my taxable or tax-deferred accounts and I'm going to start drawing out some money there."

I say, "You can do that. But before you do it, you've got another bucket—your reverse mortgage line of credit." So instead of taking dollars out and paying taxes on that withdrawal, use your other bucket. Now you can fund whatever income needs you have during deferral without incurring taxes on drawing this money out.

3. Avoiding IRMAA Surcharges

IRMAA is the income-related monthly adjustment amount. When you get Social Security, you're going to be paying Medicare Part B and Part D. They're going to withhold some money. But if you have too much money coming into your Social Security, your provisional income, that amount is going to be more.

In the article, there's a retired single lady and her threshold at the time was \$103,000. She was going to take some more money out that was going to push her over that threshold. That was going to cost her—two years after you do that, your Social Security gets reduced, Part B and D.

We said, instead of taking the extra \$20,000 or \$30,000 that pushes you over and causes your Social Security to be reduced, take it from your other source. Take it from your reverse mortgage.

4. Reducing Capital Gains

A client says, "I need to cash some assets. I'm going to pay a capital gains tax on that. I'm not happy about it."

I said, "Well, what if you use your reverse mortgage line of credit to fund whatever you

need to fund so you don't have to pay the capital gains tax?"

Capital gains has some sort of threshold. If you take out a certain amount, it's taxed at this much, but if you keep it below that, you can have very little or no capital gains. Now you've got another bucket, your reverse mortgage bucket that allows you to kind of weigh what you're going to take and what the taxation is going to be because you've got another lever.

5. Creating a Tax-Free Buffer During Market Downturns

For folks that have money in the market and you've retired and you're going to live off of that, if the market is down, say like in 2022, if you had a million dollars in the market and at the end of the year you had \$800,000 and then you say, "I've got to take \$40,000 or \$50,000 out of that." Now you've got \$750,000 versus a million because of a downturn.

The simple act of withdrawing money during the downturn not only becomes a taxable event, but it's also going to be an erosion event. If you have another bucket, the reverse mortgage line of credit, then you can minimize the taxable event. Instead of taking money from already depleted assets, take it from another bucket.

Dr. Wade's research on this says if you use a reserve bucket in the year following a downturn in the market—I don't take money from that securities bucket, I let that recover—if you do that one time, you dramatically improve the longevity of that asset. If you do it four times over a 30-year period, it's just ridiculous.

Using the reverse mortgage as a buffer asset during market downturns not only reduces taxes because you don't have to take from the asset, but it also extends the longevity of your savings vehicle.

6. Shielding Social Security from Taxation

Your Social Security is not normally taxed, but it has thresholds. If you have too much provisional income and it goes over a certain level, it can be taxed all the way up to 85%. So you want to manage the amount of provisional income you have coming in.

The example in the article was a lady who simply wanted to take an extra \$10,000 for a vacation. She thought that'd be maybe \$2,200 in taxes on that \$10,000. But what happened was that \$10,000 pushed her over a threshold. Because now that Social Security is going to be taxed at a higher level, instead of paying \$2,200, the impact was \$4,000 to \$6,000. She had no idea, but she went over a threshold.

Then to fill that gap, she says, "My gosh, I got taxed on that \$10,000, but I needed that money." So she goes back in to draw out more money to fill the hole for her income needs,

which causes more taxation. It's a kind of never-ending perpetual cycle.

David McKnight, author of "Power of Zero," says if you can avoid that Social Security being taxed, you'll add five to seven years to your retirement portfolio.

So I said, "Well, here are two things we can do. Number one, that \$10,000 you wanted for your vacation, take it from a different source. Take it from a non-taxable source." And then we avoid that particular torpedo.

7. Facilitating Roth Conversions

What if I just have too much—RMDs are coming in, and I just have too much income? Is there nothing I can do about this amount of income?

I said, "Well, there is something you can do. Because you've got high RMDs that are causing IRMAA, causing taxation of Social Security, causing ordinary income tax—if we can somehow get that tax-deferred money to non-taxable through a Roth conversion, you're sitting pretty."

They said, "Yes. So how do we do that?"

The person says, "Well, I know how to do it, but if I structure it—maybe they had a million dollars, Bob, and they're going to structure \$100,000 a year—they said, "Don, I've got to pay taxes on that \$100,000."

I said, "You do. But you can use the reverse mortgage, the growth of that line of credit, to pay the taxes on the Roth conversion." So you're going to convert the whole \$100,000 a year versus \$78,000. That means we're going to preserve taxes, we're going to enhance the growth, and we're going to mitigate some of these risks.

The last two strategies are facilitating a Roth conversion and then managing Social Security taxation by using a different asset bucket so we don't go over thresholds. Those are the seven ways that we talk about in the article. It's counterintuitive, but it's there. And 87% of retirees have access to this strategy because they own a home.

Final Considerations

Powell: In the example that you gave where someone has an \$800,000 house and they have a line of credit starting at \$236,000 at age 65 that grows to \$378,800 by age 85, when they take money out of the line of credit, it obviously reduces the amount in the line of credit. Is that correct?

Graves: Well, we'll make sure we get the right graphic in there. But your question was, if

they take money out of the line of credit...

Powell: Well, it reduces the line of credit, obviously, but the line of credit does continue to grow even though you still take money out.

Graves: Yes, that's correct. In 1988, when Ronald Reagan signed this into law at the seating of the 100th Congress, the architects of the program said this: the unused portion of the home equity conversion mortgage, nickname reverse mortgage, the unused portion of that line of credit will grow. Not because the house is growing, because we said it's going to grow. So they baked it into the program. So it grows regardless of the home's underlying value. Yes, the unused portion always grows.

Powell: All right, now we've covered a lot of ground. Anything we missed or bears reemphasizing?

Graves: I think we covered it. Read the article. Thank you, Bob Powell. It's always delightful to be here.

Powell: Likewise, Don, thank you.
