FINANCIAL FACELIFT

How long can Dennis, 66, and Sylvie, 61, stay in their home?

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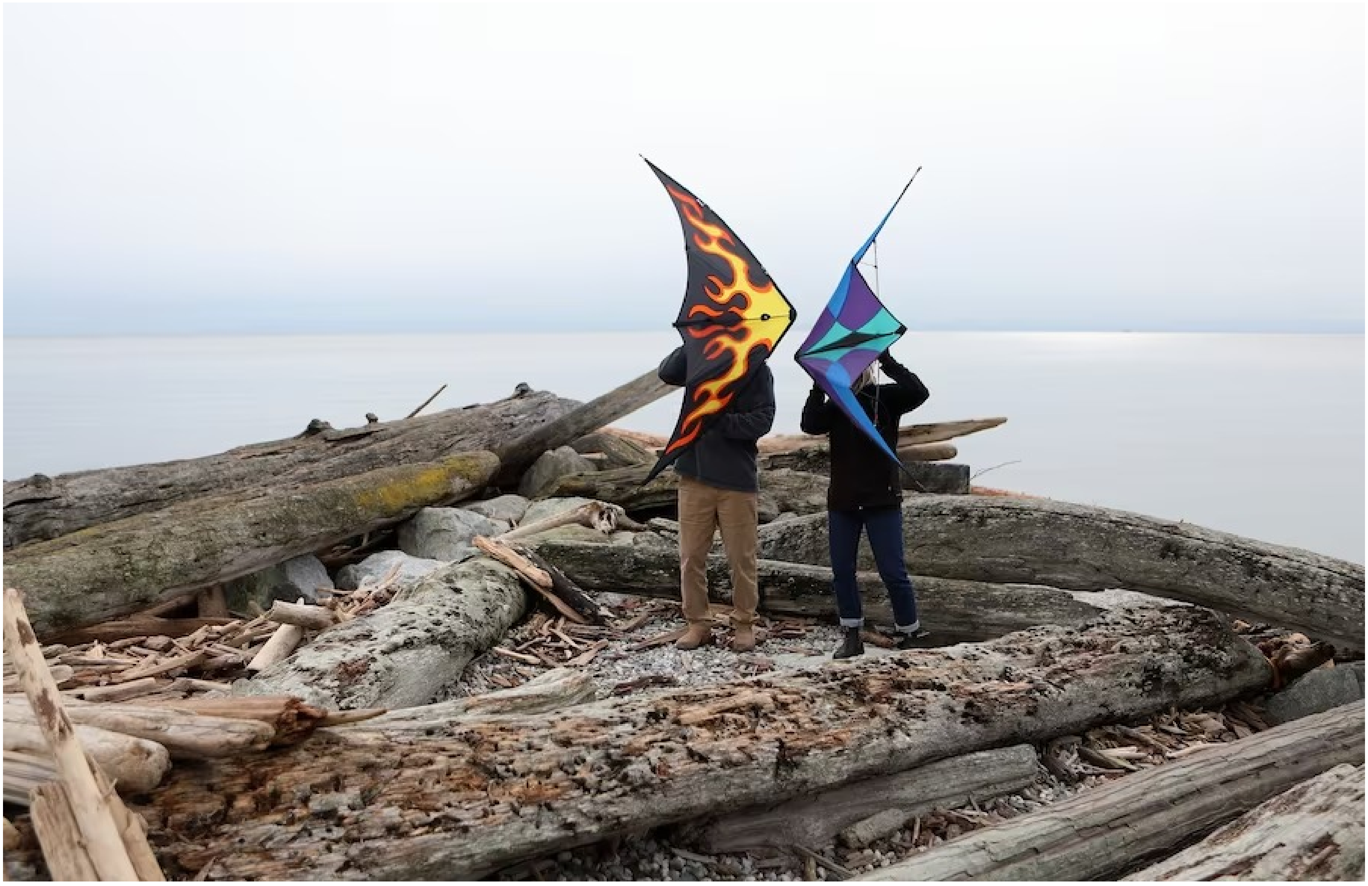

Dennis and Sylvie.

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A few years ago Dennis and Sylvie moved from Southern Ontario to British

Columbia, where they bought a house and a rental property. Sylvie, who is 61, has already retired. Dennis, who will turn 66 this spring, runs a general contracting business and hopes to retire at 70.

Dennis earns about $80,000 a year in self-employment income and has no pension plan. Sylvie gets a defined benefit pension indexed to inflation of about $36,000 a year. They have two adult children, age 23 and 27.

Short term, they want to pay down their mortgage loans and hold on to their investment property for a few more years. Their main goal is to stay in their home as long as possible, "ideally for 15 or 20 years," Dennis writes in an e-mail. "Obviously, our investment property will have to be sold at some point to support our retirement funding," Dennis writes. Ideally, they would like to have $100,000 a year to spend after tax.

We asked Steve Bridge, an advice-only financial planner at Money Coaches Canada, to look at Dennis and Sylvie's situation. Mr. Bridge holds the certified financial planner (CFP) designation.

What the Expert says

Dennis and Sylvie will need the proceeds of the rental property sale to fund their retirement, Mr. Bridge says. He assumes they sell it when Dennis retires in four years or so.

They also need to take a close look at their spending, Mr. Bridge says. “It’s not an easy exercise, but it is probably the most important number when it comes to retirement planning.”

So far the rental hasn’t been a particularly good investment. “From my calculations, they are losing at least $6,500 a year on the rental property’s cash flow,” Mr. Bridge says. Gross rent is $43,200 a year. They have only a small amount budgeted for repairs, maintenance and upgrades and nothing allowed for lost opportunity cost – what they could earn if they invest their money elsewhere, the planner says. “A negative cash flow is common in the Lower Mainland. The building is not the source of income they think it is.”

Sylvie and Dennis want to stay in their home, which they value at $2.1-million. The mortgage is $603,000. They could free up a substantial amount even after the mortgage if they downsized to a less expensive home, the planner says.

"It's up to them to decide if they would like to have more money to spend in retirement or if they would rather stay in their home," he says. Downsizing to a less expensive home would allow them to live mortgage-free and have more money to spend in retirement.

There are also estate planning considerations, the planner says. Is leaving their children a larger inheritance important? "If so, then staying in their home and spending less on themselves would leave the equity in their principal residence intact at their passing."

Currently, they only allocate $5,000 per year to home repairs, maintenance and upgrades for their principal residence. A good rule of thumb is to set aside 1 per cent of the home's value annually, the planner says. "Large home expenses tend to be lumpy, so you may go a few years with very little spent, but then something comes up that costs tens of thousands of dollars or more."

For Dennis and Sylvie, this means budgeting $21,000 a year for such repairs rather than $5,000. "Underestimating home repairs and maintenance is perhaps the most common thing I see when people are determining future spending needs," Mr. Bridge says. Car repairs, travel, and furniture and appliances also fall into this category. “Budgeting for lumpy expenses is hard.”

Once Dennis retires and they sell their rental property, they will need a tax-efficient drawdown strategy, Mr. Bridge says. Asset allocation and investment fees also need to be reviewed. “Consider speaking with two or three investment professionals, someone who charges 1 per cent or less of their portfolio each year and who will clearly explain everything and help them understand what is where, the purpose for owning that particular product, etc.”

Some of their cash on hand needs to be set aside for Dennis’s business operations. “They have $175,000 of cash so I allocated $75,000 for this purpose.” They also want to buy a car in five years. “I allotted $30,000 for this goal.” The remainder can be invested for the medium to long term.

Sylvie invested a small amount in a tax-free savings account recently, but Dennis has not yet opened one. “I suggest confirming their current TFSA room on their My CRA account and then using their cash on hand to invest in their TFSAs for the medium to long-term,” he says. “The optimal long-term use of a TFSA is for investing.”

Mr. Bridge considers three alternative scenarios. Assuming they sell their rental property in 2028, when Dennis is 70 and stops working, and they downsize their home in 13 years (2037) to a home with a value of $1-million in today’s dollars, “they are going to be okay,” the planner says.

That's based on an asset allocation of 10 per cent cash, 40 per cent fixed income and 50 per cent stocks or stock funds, giving them a 4.52 per cent average nominal rate of return.

In this scenario, their after-tax sustainable spending would be $123,842 a year from Dennis's age 70 to Sylvie's age 95 – higher than their target.

In the second scenario, they could choose to stay in their home for 20 years instead of 13 (to Dennis's age 86 in 2044). Their long-term sustainable spending would be almost identical to the above projection where they downsize in 13 years. The difference is that they run out of cash in 2037 and build up debt of $801,000 until they sell their home in 2044, the planner says.

They would need to borrow against the equity in their home in the form of a home equity line of credit (HELOC) or reverse mortgage. This debt would be repaid when they downsized.

In the third scenario, they spend to their target of $100,000 a year instead of to their maximum sustainable. They build up $111,000 in debt for a couple of years until they downsize, but they leave a larger estate.

The forecast assumes Dennis begins collecting Canada Pension Plan benefits at age 70 and Sylvie at 65. He will get the maximum benefit and she will get 60 per cent. They both begin collecting Old Age Security benefits at age 70.

“A good exercise for Dennis and Sylvie would be to get clear on current average monthly and annual spending,” Mr. Bridge says. “This would help them understand their target retirement spending better and also how much of a surplus or deficit they currently have.”

Client Situation

The People: Dennis, 65, Sylvie, 61, and their two adult children, 23 and 27.

The Problem: If Dennis retires at 70, can they afford to stay in their home for 15 to 20 years and still have $100,000 a year after tax to spend?

The Plan: Sell the investment property when Dennis retires and invest the proceeds. Consider selling the primary residence and buying a less expensive one sooner rather than later. Review lifestyle spending and retirement spending goals.

The payoff: A clear-eyed look at setting priorities and formulating goals.

Monthly net income: $9,665.

Assets: Cash in bank $175,000; his RRSP $40,000; her RRSP $40,000; residence

$2,100,000; rental property $1,100,000. Total: $3.45-million.

Estimated present value of her DB pension: $590,455. This is what someone with no pension would have to save to generate the same cash flow.

Monthly outlays, residence: Mortgage $4,270; property tax $485; water, sewer, garbage $150; home insurance $230; electricity $110; heating $180; maintenance $290; garden $215; car insurance $100; fuel $325; oil, maintenance $30; parking $30; groceries $1,000; clothing $75; gifts, charity $100; vacation, travel $500; dining, drinks, entertainment $1,350; personal care $75; club memberships $50; sports, hobbies $50; subscriptions $55; other personal $200; doctors, dentists $150; drugs supplements $200; health, dental insurance $55; phones, TV, internet $300. Total: $10,575. Deficit $910.

Liabilities: Residence mortgage $603,000; rental mortgage $605,000, both 6.1 per cent variable. Total: $1,208,000.

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