Already carrying two mortgages, can Carl, 62, afford Florida?

JOEL SCHLESINGER
Special to The Globe and Mail
Published Wednesday, Feb. 05 2014, 5:00 AM EST

This is part of a series of portfolio makeovers that focus on the issues of investors who are in the 50-plus age range.

Carl's had enough of ice and snow, but he leaves his house each workday, braving the -30 C Prairie wind chill, knowing he won't have to endure Old Man Winter's icy grip much longer.

The 62-year-old Alberta community support worker is close to joining thousands of other Canadians snowbirds who flock to the southern United States every year when the snow flies.

"I'd love to retire at 65 officially, but I still enjoy my work so I probably only will take [some of] the winters off at first to visit my sister in Florida, and come back and work the rest of the year," says Carl, a divorced father of four adult children.

While he knows he can afford semi-retirement until 67, living off half of his current salary of $60,000 a year, OAS, CPP and savings, he is concerned about the sustainability of his plan once he pulls the plug on work fully.

Carl's net worth is more than $650,000, but more than two-thirds is tied up in real estate – his principal residence and a rental property, on which he owes a combined $428,528 in mortgages.

Ideally, Carl would like to pay them off within the next decade and then sell the rental, using the proceeds to fund the rest of his retirement, but he's not sure his current portfolio can support his retirement lifestyle until he sells.

Carl says he is open to the alternative – selling the rental property sooner if that makes more financial sense – but he wants a financial checkup to help weigh his options, so he can confidently spend his winters in fairer climes.

"Like most Canadians, I want to know in the latter part of my life I won't have to worry too much about finances."

Certified financial planner Tom Feigs with Money Coaches Canada and Royal Bank of Canada financial planner Ruwan Liyanage, a certified professional consultant on aging, examined Carl's financial situation and have the following recommendations.

The basics:
– RRSP: $110,327 in balanced portfolio mutual funds
– TFSA: $29,015 in cash and GICs
– LIRA: $22,089 in a balanced portfolio
– Savings account: $29,488
– Non-registered GIC: $5,605
– Work defined contribution pension: $63,000
– Principal residence value: $415,000
– Rental home value: $405,000
– Mortgage on principal residence: $199,000 at 3.5 per cent
– Mortgage on rental property: $229,528 at 3.5 per cent
– Rental income: $1,771 a month

Mr. Liyanage's advice

1. Create a retirement income plan that allows for flexibility.
Most of Carl's retirement savings are tied up in registered savings. These are fully taxable accounts, so he should develop an investment strategy whereby his growth investments are held in non-registered accounts, in which capital gains and dividends are taxed at about half the normal rate, while keeping interest-bearing investments, whose profits are fully taxable, inside the RRSP. Furthermore, he can take advantage of provincial legislation regarding LIRAs (locked-in retirement accounts) to unlock the majority of the assets, transferring the money to his RRSP. "This will create flexibility of income because he will not be restricted to the amount he can withdraw from the account in the future." Carl should, however, consider creating a RRIF once he turns 65 so he can draw at least $2,000 a year from the account tax-free because he is eligible for the non-refundable pension income tax credit. "As Carl lives in Alberta, this should lower his taxes payable by approximately $430."

2. Aim to pay down the mortgage on the home first.
Carl is paying $400 extra every month on his rental property to pay it off as quickly as possible. Yet he should be using the extra cash to pay off his principal residence because the interest costs on the rental mortgage are tax deductable whereas the interest he pays on his home's mortgage is not. He should also apply some of his savings and GICs – more than $36,000 – to the home mortgage to further shorten its amortization. While it is generally recommended to have an emergency reserve, as an alternative, Carl could rely on a home equity line of credit in case of emergency. Although it would mean he would have to incur debt if he needs cash in a pinch, it makes more sense for him to use his savings to pay off debt today because he is paying more interest on the mortgage than he is earning in savings accounts and GICs.

3. Selling the rental property will free up cash flow.
Carl is paying more than $1,600 a month in mortgage payments on the rental property and another $1,270 on the mortgage on his home. If he sold the rental, he would likely have almost enough profit after paying taxes to pay off the mortgage on his home. "By

selling the rental property and paying off both mortgages, Carl would reduce his monthly expenses and only need $2,273 per month to maintain his lifestyle," Mr. Liyanage says. "By reducing the income needed, he should be able to meet his lifestyle needs until the age of 90."

Mr. Feigs's advice

1. The rental property is bleeding cash.
The whole point of investing in real estate is to ensure it is a profitable venture, but Carl's rental is actually resulting in negative cash flow. "The annual gross rental income should be no less than 8 per cent of the property value and, more than anything, should be producing positive cash flow that at least compensates Carl's time and effort – both of which are not happening in this case," Mr. Feigs says. "Unless rent can be raised to $2,700, this property should be sold."

2. Carl needs more retirement savings than he has to retire comfortably.
Mr. Feigs says Carl needs about an annual income of $36,000 ($30,000 for basic costs and $6,000 for discretionary) after taxes to retire comfortably well into his 90s. "Coupled with CPP and OAS income, Carl would need savings totalling $500,000 in RRSP, TFSA and non-RRSP accounts." With a little more than $250,000 in RRSPs and other accounts, he is well short of this goal. Carl simply does not have the additional cash flow in his budget to increase his savings rate nor the time to almost double the size of his retirement nest egg before retiring. In addition, most of his income is going toward paying the mortgages. Consequently, the best strategy for Carl to meet his retirement income needs is to sell his rental property.

3. Increase his savings rate prior to retiring.
After selling the rental, Carl would have almost enough cash to pay off most of the mortgage on his home. Yet Carl would still have a long way to go to save enough for retirement. To help increase the cash flow he can devote to his savings, Carl should downsize his home, paying about 30 per cent less and entirely eliminating his mortgage. With the additional cash in his budget he can increase his RRSP savings to $900 a month and monthly TFSA contributions to $450. Mr. Feigs says Carl should also work full-time at least one more year than planned and continue part-time until he reaches the $500,000 goal. At that point, he should consider buying a life annuity to provide himself with another source of guaranteed income. "I recommend Carl use most of his RRSP savings – about $250,000 – to fund a life annuity while his non-RRSP investments can be used to top up his lifestyle expenses," he says. "The annuity also spreads Carl's income evenly which keeps his income tax to the lowest possible amount and the fees are lower than Carl would experience in investments."