How can debt-laden Pauline and Perry prioritize paying off family loans?

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Like many Canadians, Pauline and Perry have chosen real estate as their long-term investment of choice, building a home and an investment property in a Victoria suburb.

Pauline, who works in health care, has a defined benefit pension plan at work, which will go a long way to covering their retirement income needs.

Perry is 42, Pauline, 41. Together, they bring in about $210,000 a year. They have two children, at the ages of 7 and 10.

The flip side of a growing and leveraged real estate portfolio is debt and Perry and Pauline have plenty of it – to family members, to the bank, to the credit card companies.

"We are struggling to prioritize and organize our multiple personal loans and bank loans incurred while building our home and rental property five years ago," Pauline writes in an e-mail.

"We have pretty well-paying jobs, except my husband has been laid off for four months (a result of the pandemic) and is just returning to work now," she writes. "But we have been unable to pay off assorted family members and credit cards while covering the costs of our growing and busy family." Now their family members would like their loans paid back "pronto," Pauline writes. "We would love to move out of our overdeveloped neighbourhood to somewhere more rural," she adds. They would keep their current home as a rental.

The mortgage on their rental property – which has positive cash flow – is up for renewal in November, 2021, "and we feel like there are a million different things we could look at and prioritize," Pauline writes. "Help!"

Should they increase the size of the mortgage when it opens up to pay off the family loans?

Their goal is to retire at the age of 65 and spend $100,000 a year after tax.

We asked Steve Bridge, an advice-only certified financial planner and money coach at Money Coaches Canada in Vancouver, to look at Pauline and Perry's situation.

What the expert says

Pauline and Perry's first priority is to repay the $103,015 in loans to three family members as quickly as possible, Mr. Bridge says. As it is, they are paying the minimum $485 a month on their credit cards and line of credit and $1,250 a month to family.

They don't seem to have a good grip on their finances. In their initial application form, it looked like Perry and Pauline were spending every cent they got and more. A closer look shows they actually have – or should have – a monthly surplus of $1,495, the planner says. As well, they were not sure when their rental property mortgage was coming up for renewal.

He suggests they use some of the surplus to contribute more to the children's registered education savings plan and the rest to pay off their family debt more quickly. Contributing $420 a month in total to the RESP would maximize the Canada Education Savings Grant, he adds.

Pauline and Perry could increase the payments to their relatives by $1,100 a month – to $2,350 from $1,250 – from now until next November, when their rental property mortgage comes up for renewal, he says. They could then roll the remaining balance of $72,465 – $103,015 minus $30,550 ($2,350 times 13 months) – owed to their relatives into their rental mortgage and pay them off.

Rolling the family debt of $72,465 into the rental mortgage – which will be $313,000 at the time of renewal – would take the mortgage to $385,465. (The loan interest would be tax deductible because the money was borrowed to earn rental income.)

Once the personal loans have been taken care of, Pauline and Perry will be able to redirect more of their cash flow to monthly consumer debt repayments. A cash-flow management plan or budget will help with this. If they put $2,800 a month to the consumer debt starting next November, they can have it paid off in three years, the planner says.

"I highly recommend they set themselves up to be mortgage and consumer debt-free by Perry's age 60," the planner says. "This means paying the mortgage on their principal residence – about $495,000 – off over 16 years, max." This will give them more flexibility when it comes time to make retirement decisions, he adds.

"On the flip side, it will mean increased mortgage payments (due to the shorter amortization), so decisions will have to be made around spending priorities in the coming years," Mr. Bridge says. The rental mortgage interest is tax-deductible, so they could continue with the existing amortization.

"I would leave buying another house off the table for now until their debt is paid off and they have a clear plan for the future."

As for their retirement spending goal of $100,000 a year after tax, they actually only need $67,000 a year to maintain their current lifestyle – as long as they are free of both home mortgage and consumer debt, Mr. Bridge says. The $67,000 a year includes an extra $4,000 a year for travel, bringing the total to $10,000, and an increase in health care spending to $3,600 a year from $300 now, he adds.

"Even better, they could very likely retire five years earlier and still have the lifestyle they want," the planner says. They have a good retirement income base with Pauline's pension. Her earliest unreduced lifetime annual pension is $45,800 for a 100-per-cent survivor benefit, plus a bridge benefit of $12,228 to 65.

At 65, they will both receive full Old Age Security benefits ($14,700 a year) and full Canada Pension Plan benefits ($28,200 a year).

"This is $88,700 a year in guaranteed income from age 65 onward, not including net rental income," the planner says. The rentals could add $38,000 a year in gross income, he says. "Note that home/rental property repairs, maintenance and upgrade expenses are very hard to predict, and that net rental income is fully taxable at their marginal rate," the planner says.

Perry is not contributing to a registered retirement savings plan and because he is in the 38.29-per-cent tax bracket, it would be worth his while to contribute, Mr. Bridge says. A $10,000 annual contribution would save him an estimated $3,616 in taxes a year.

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Client situation

The people: Perry, 42, Pauline, 41, and their two children

The problem: How to pay off their loans to family and get their consumer debt under control.

The plan: Draw up a budget and use the surplus to increase loan payments to family. When their rental mortgage comes up for renewal next year, pay family members off by rolling the loans into a higher mortgage loan.

The payoff: A simplified long-term debt repayment plan.

Monthly net employment income: $11,440

Assets: Bank accounts $1,050; her TFSA $1,100; her RRSP $9,815; estimated present value of her defined benefit pension $686,880; RESP $16,000; residence $704,000; rental property $685,000. Total: $2.1-million

Monthly outlays: Residence mortgage $2,645; home insurance $75; property taxes $350; utilities $320; water, sewage, garbage $75; home maintenance $285; garden $50; car lease $275; car insurance $265; fuel $175; car repair and maintenance $150; groceries and cleaning supplies $900; clothing $85; child care $40; credit cards, credit lines $485; loan payments to family $1,250; personal care $50; dining out, drinks, entertainment $525; pets $90; children's activities $440; other discretionary $120; phones, TV, internet $325; gifts $100; travel $500; life insurance $270; health care $25; RRSP $25; RESP $50. Total: $9,945. Surplus: $1,495

Liabilities: Residence mortgage $494,410; rental mortgage $322,545; line of credit $43,500; credit cards $9,650; loans from family $103,015. Total: $973,120