FINCOMMUNICATIONS

**Home-made capital**

There are many things to consider before downsizing or relying in other ways on your home to partly fund your retirement, writes Mark MacSymon.

It's quite prevalent for South Africans to rely on their homes to provide a portion of their retirement capital. People often downscale either before or during retirement into smaller, lower-maintenance homes in secure retirement complexes, or into apartments or smaller free-standing homes, although this may be for reasons other than retirement funding.

The degree of the reliance on the capital made available from selling a family home varies from family to family, depending on retirement capital already accumulated. In many instances, homes are the most valuable asset that retirees own, but they are usually the last asset called on to raise cash. People take comfort in the fact that their homes appreciate in value despite them being lifestyle assets that are expensive to maintain, which, in effect, reduces the perceived growth over time.

It's also widely known that many South Africans do not make sufficient provision for retirement. While they are earning, there is the tendency to adjust their lifestyles upwards, often unnecessarily so. This is best known as "lifestyle creep" and results in insufficient savings for rainy days and long-term income security.

The other classic hiccup merely is the failure to plan. There is a surprisingly high number of people who don't have documented financial plans that include reliable strategies to ensure a comfortable retirement, and which provide choice in lifestyle during retirement.
As they say, "if you fail to plan, you plan to fail".

**Options, risks and costs**

There are a few ways in which to release equity from a home for retirement, the most common being to sell and downscale – that is, to buy another house that is less expensive. It's important to be aware of the type of ownership of the new property (for instance, sectional title, life right or share block scheme) and to understand how that type of ownership will affect your freedom to make decisions regarding the property.

The main risk associated with downscaling is whether it will release enough capital to justify the move. There is a significant number of costs involved in moving, including:

- Funds required to get the house and garden well presented for sale,
- Estate agent's commission (which varies between 4 and 7%),
- Legal fees,
- Cost of compliance certificates, and, importantly,
- Transfer duty.

It's obviously critical to buy for significantly less so that there isn't the need to downscale yet again at a later stage. Undertaking the same activity five years down the line would be a particularly expensive exercise. However, the price of the replacement home should largely be determined by understanding what cash flows are required to ensure income security over a planned retirement horizon. It's also important to be aware that properties can take many months to sell, which could present a cash-flow problem if you are immediately dependent on the release of capital.

An option would be to sell the family home and rent another, which is suitable if you require flexibility, as you may want to live in various places before settling down. This option isn't recommended if you want to live in a home that you ordinarily couldn't afford to buy, as the rental will most likely to be too high a drain on your budget. It's also important to be reminded that when renting, there's no wealth creation or return on investment, and the agreement is usually very much in the landlord's interest.

Some retirees choose to rent out part of their house to generate additional income. This option is arguably better in most instances than to sell and rent. It provides more security, as you're not at the mercy of a landlord who may increase rental payments by more than inflation, sell the property or even choose to live in the home. It also allows you to maintain the property and defer the costs associated with selling.

However, there are risks involved in renting out part of your home, the most significant one being the ability to find and keep a trustworthy tenant.

**What does the taxman have to say?**

It's critical to be aware of the tax implications of the different options before you make a decision. When a primary residence is sold, capital gains tax (CGT) is applicable on the gain over and above the R2-million exemption. Forty percent of the gain is included in your income and taxed at your marginal income tax rate.

CGT was implemented in South Africa on October 1, 2001. If the property was bought before then and the house wasn't valued in October 2001 (which would have determined the base cost), there are two ways in which your CGT liability can be calculated. There is the "20% of the proceeds" method, or a formula that determines the base cost using the property's average growth rate between purchase and sale, taking into account the cost of improvements you may have incurred before and after October 1, 2001.

If you scale down and buy another property, transfer duty will have to be paid on the new property, and it may be more than you realise. For instance, if you purchase a property for R 2 000 000 million, the duty will amount to R 65 000, and if you purchase R 5 000 000, it amounts to a staggering R 383 000. Transfer duty is not applicable to new property developments where the developer pays VAT, or on a property in which you have life rights.

If your plan is to rent out part of the home for retirement income, the rental income is subject to income tax, but the direct expenses incurred to generate this income can be deducted. These may include a percentage of rates and levies, electricity, insurance, security, repairs and maintenance, ADSL, DStv, furnishings and fittings and cleaning. Ideally, at this stage of life, bond repayments should be a thing of the past, but if not, the interest portion of bond repayments, apportioned to the rental space, can also be set off against your rental income.

It's also important to bear in mind that if the property is sold at a later stage, the portion of the primary residence that has been rented out will not be subject to the primary residence exclusion of R2 million. This is similar to when a home is used as a base from which to run a business and the owner deducts part of the running costs of the home from the business's income for tax purposes.

**Emotions, an essential consideration**

There are seldom instances where both spouses are comfortable with and united in the decision to sell a family home. For instance, one spouse may want to move out of a city and the other to remain close to family and friends. Invariably, these decisions are not simple, and communication, consideration and compromise are required.

Retirees also need to overcome the emotional attachment to the property that may have served as the family home for many decades. There's also the fear of change based on the uncertainty of experience in a different environment.

These emotional factors can be overcome through rational discussion with a professional financial adviser (preferably one with the Certified Financial Planner accreditation) who can quantify the options and assist in making a realistic decision. It's often the case that over and above the need to release some capital from the sale of a home, retirees' budgets don't allow for the ongoing maintenance of their family homes. As a rule of thumb, it's necessary to spend at least 1% of the value of a home per year on maintenance. So, for instance, if your home is valued at R6 million, your maintenance bill may average a significant R5 000 per month over time.

It's imperative before making the change (whether it's to buy a less expensive property or to rent one) to consider security, proximity to amenities and an environment that supports a good quality of life. It's also essential to evaluate the selection of a new home regarding physical and emotional health. Retirement villages are good options in this respect as there's usually a nurse on-hand 24/7, frail-care facilities and access to a communal gym, swimming pool and restaurant.

**Where to with the funds after the sale?**

The most appropriate way to invest released capital from the sale of a property will differ for each investor. You should consider all your assets (and liabilities should there be some) including discretionary and retirement investments, other properties and businesses. First and foremost, it's usually good to get rid of all debt.

After that, you need to define the family's short-, medium- and long-term investment objectives, decide on their overall asset allocation and invest accordingly. This can amount to a combination of interest-bearing, income generating, preservation and growth assets.

Determining an optimal asset allocation should include a thorough risk analysis based on your propensity and need for risk as well as your capacity for loss. An in-depth risk analysis will determine the different returns required for varying investment goals and help in allocating the funds to appropriate assets.

Your primary goals should be a steady income that increases annually by inflation, appropriate medical cover and sufficient funds for emergencies. Secondary goals may be to travel or to fund a grandchild's education.

These investment objectives have different time horizons and capital should be allocated to them accordingly. Short-term goals prioritise capital preservation, and the allocation will usually include money market funds, short-duration bonds and quality corporate debt. Investment goals of 7 to 10 years and longer should predominantly involve local and offshore equities.

**The all-important aspect of timing**

The decision as to whether to rely on a family home for retirement should be thought out well in advance. Retirement planning is an on-going process and there shouldn't be any surprises and too many changes required when the time comes to scale down.

Investors benefit tremendously from undertaking cash-flow analyses, which determine time frames over which decisions can reasonably be made. In some instances, there's a reliance on an income from discretionary capital for ongoing living expenditure with the plan to sell the family home for a capital injection at a later stage.

It's important to be aware that property is a very illiquid asset and it may take time to sell. Thus, if you are highly reliant on selling your property, it should be put on the market well in advance.

**Property, not always the sure and only thing**

At the end of the day, there's risk associated with any investment and there shouldn't be total reliance on the sale of a home for retirement. The good old principle of diversification applies, which means not putting all your eggs in one basket. It's far safer to invest in a range of assets, including tax efficient investment vehicles and equity-based unit trusts, throughout your working career.
Retirement years are the golden years. Prepare well for them.