Downsizing

12 insights to improve your thinking on the subject

WealthAdviser

Contents

Before you get started

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Information in this handbook is no substitute for professional financial advice.

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Letter from the Wealth Adviser Library

Dear Reader

Welcome to the Wealth Adviser Library

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

Knowledge gives you a huge advantage

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

Take the next step

Wealth Adviser (a division of WT Financial Group Limited) supports more than 400 privately owned and operated advice practices around the country. We invite you to engage with one of our advisers to discuss what it was you were hoping to achieve when you obtained this handbook, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find details on how to book an appointment.

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Introduction

For many Australians, it is a reality that at some point the family home will be sold (voluntarily or not) to prepare for, fund or fuel retirement. It is a complex decision with many moving parts. Like most complex, multi-dimensional financial decisions, a financial adviser is best placed to help you navigate through all the financial considerations and trade-offs.

Following is an outline of some of the most important thoughts and insights into the subject.

#1 – Financial benefits of the family home

The majority of wealth in Australia is in property and the majority of that is in the family home…and for good reason. A combination of unique property market dynamics that have driven prices north for decades plus a range of tax benefits have made the family home the store of most people's wealth. So let's have a quick look at what the main tax benefits are:

- Capital Gains Tax Free: This is the big one, it's hard to understate how important a factor this is, especially when the asset actually grows in value. It's not worth much being CGT free, if there is not much gain to begin with. Australians who live in the major capital cities have benefited the most from this.
- No Land Tax: Unlike investment property that at some point can attract Land Tax, the home doesn't incur this cashflow burden.
- Assets Test Exempt for Age Pension calculations: I do think of this as a "tax benefit" because if it was wholly or partially assessed then you would be "taxed" via a reduction in your Age Pension. More on this one later.

#2 – Understanding your balance sheet

It's important to see you balance sheet correctly. If you don't see it honestly, you hinder your ability to make good decisions.

What is your net worth? All assets less all debt. That is the starting point of any discussion about downsizing.

What is the value of your home?

Once you subtract the value of the home from your net worth, you are left with a number. That number is what is available to fund your retirement. If you are approaching retirement and you still have a mortgage and debts, it is not uncommon for the value of the home to be more than your net worth.

For example:

Home	$900,000
Mortgage	$500,000
Other Assets	$100,000
Super	$350,000
Total Assets	1,350,000
Total Debt	$500,000
Net Worth	$850,000
Subtract Home Value	-$900,000
Funds Available for Retirement	-$50,000

If these were the numbers as you are preparing to retire, and there was not likely to be an inheritance to tidy up the debt, downsizing is almost a certainty.

#3 – Age pension considerations

There is a favourable bias towards the manner of embedding the home in Age Pension calculations, as the specific value of the home is actually included. It can often lead to government support distortions as you can have a $3m home and not much else and qualify for the full Age Pension.

This bias actually inhibits retirees from restructuring their wealth to take capital out of the home and generate an income with it. Why would they when that would lead to a reduction in pension?

The full Age Pension is about $34,000 for a couple and is an indexed lifetime payment. To purchase the same income stream in the form of a private annuity, you would need close to $1m. The capital value of any reduction is significant so it is very rational to want to "hide" one's capital in the family home.

#4 – What does the word "downsize" mean?

Many clients have spoken about downsizing over the years and in many of those cases what they were referring to was a reduction in space and size, but not a reduction in capital value. In some cases they were "downsizing" to a more expensive apartment closer to the city!

Financial advisers think of the word in terms of a reduction in price. Moving to a cheaper home, and in doing so freeing up capital for a wide range of purposes such as:

- Debt reduction (most common reason)
- Top up super
- Helping the kids
- Funding some travel in early years of retirement.

#5 – Timing… when to do it?

If you decide to downsize, you are left with the big decision of when?

Do you do it sooner rather than later, to free up capital to spend during the healthier more active years of your retirement and to do all the travelling that you always wanted to do. But risk less financial security in later years?

Do you delay it as long as possible and hopefully pick up more gains on your home (assuming you are in a growth market) to try to increase financial security in later years?

As with all good questions, the answer is, It depends. It depends what you want to value. It depends on how financially disciplined you are. If you have poor financial discipline and spend too much in the early years you are likely to pay for that with increased financial stress in later years.

There is no perfect answer, just an awareness of the questions that need to be considered and the balance that needs to be found.

#6 – Sequence

As a general rule it is best to sell first and then buy, even if that means renting for a while. Obviously if you can afford to comfortably own two properties and service the loan required to do so, then that might be an option for you. But most people would be putting themselves under a lot of financial stress in that situation.

That financial stress often translates into a poorly negotiated sale of the old home as it was conducted under pressure. You are putting yourself in a position where you are likely to accept a less than ideal price for your old home.

If the sequence is right, and you are renting while looking for the new home, you can take your time and wait for a good property that you negotiate for without pressure and increase your chances of buying it at a good price.

#7 – What to do with the cash?

You have sold your home, you are now renting and looking for your new home. A common question is what to do with the cash?

The answer is that it needs to be totally "No Risk", so a high interest bank account or a short dated Term Deposit e.g. 90 days. Buying shares or even diversified managed funds will embed volatility into the money and that can cut both ways quickly if market conditions change.

#8 – Forced or choice?

Do you have to downsize? That is the most important question to come to terms with. If you don't need to, then it is a lifestyle choice. But if you need to, it's a financial choice.

The answer to this question lies in your balance sheet (Point 2) and in the amount of income you want/need to maintain the lifestyle you want/need.

If you need to downsize, the sooner you realise it the better. It needs to be planned for as best as possible and the more time you have to do it, the more likely you are to make.

#9 – Managing debt during your working life

How you manage your debts during your working life directly impacts the types of decisions you will be faced with during retirement.

If you are disciplined in reducing your debts, especially you non tax deductible home mortgage you are less likely to be forced to downsize.

If you have borrowed too much or don't pay off the principal of your debt enough, then a downsize might be the preferred way to "reset" your situation and become debt free and create enough capital for income generation.

This is one of the many benefits of working with a financial adviser, someone who can help you work out the multi-dimensional nature of these considerations.

#10 – Inheritance and downsizing

There is a clear correlation between likely/certain inheritance and the need to downsize. It is certainly part of the thinking and decision process. It is sometimes an issue that clients feel uncomfortable discussing or admitting reliance on.

You need to weigh up your decision making timeline with the timeline of your likely inheritance.

#11 – Frictional cost

The costs of selling and buying are often underestimated, but the shape of the number is about 8%.

Selling a property will cost you about 3% and buying into a new one will cost you about 5%. So the simple maths is about 8% (although the price of each property will be different).

This needs to be part of the thinking as sometimes spending that money on home modifications and a makeover is a better way to spend the money rather than the selling to buy into a "better" home.

#12 – Living off home equity

Downsizing is really a process of "equity release". In that context, it needs to be discussed along with other equity release options currently available such as reverse mortgages and shared equity strategies.

Other equity release options could be a better way to release capital and increase income while "buying time" to stay in your current home and maybe come back to the downsize question many years down the line.

You could think of it as a staggered downsize with different tools and strategies used at different stages of your life.

#13 – 2017 Budget – Super proceeds of $300,000 proposed from downsizing your home

On Tuesday 9 May 2017, the Treasurer, Scott Morrison, released the Government's 2017/18 Budget.

The Government proposed to allow an individual aged 65 or over to make a non-concessional contribution of up to $300,000 from the proceeds of selling their home from 1 July 2018. These contributions will be in addition to those currently permitted under existing super rules and caps and they will be exempt from the existing age test, work test and the $1.6m total superannuation balance test for making non-concessional contributions (which applies from 1 July 2017).

The measure will apply to sales of a principal residence owned for the past 10 years or more. Both members of a couple will be able to take advantage of this measure for the same home. The measure seeks to reduce a barrier to downsizing for older people to enable more effective use of the housing stock by freeing up larger homes.

Note that the proceeds from downsizing a home in this manner are not proposed to be exempt from the Age Pension assets test.

Take the next step

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We now invite you to take the next step and meet with an adviser to discuss what it was you were hoping to achieve when you downloaded this handbook and to establish if we can help you achieve your goals and objectives.

Next you will find details on how to book an appointment with an adviser.

We look forward to meeting you soon.

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Date ________________________

Time ____________ am/pm

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