FINANCIAL FACELIFT

Should Melissa, 60, sell her condo or keep it as an investment property?

DIANNE MALEY
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When her mother fell ill last year, Melissa flew from her Toronto-area home to British Columbia to help care for her elderly parent.

Fortunately, Melissa is able to work remotely at her $120,000-a-year managerial job.

Soon after arriving in B.C., she decided to rent out her mortgage-free condo, valued at $600,000, and remain in her mother's house, which she will eventually share with her sister.

Melissa is 60 years old and single with no dependants. She enjoys her job and plans to work to age 65.

She asks whether she should sell her condo in a few years or keep it as an investment. Her rental income after all expenses but before taxes is about $19,000 a year, for a return of about 3.2 per cent.

"Condo investment is a bit tricky because condo fees increase yearly," Melissa writes in an e-mail. "At some point the fees will outweigh the property's appreciation." That could happen in four or five years. "Does it make financial sense to sell at that point?" she asks. Or should she keep it to diversify her investments?

When she leaves the work force, Melissa plans to spend winters in a warmer climate. Her retirement spending goal is $60,000 a year after tax.

We asked Vikki Brown, a certified financial planner at Modern Cents, an advice-only financial planning firm in Toronto, to look at Melissa's situation.

What the expert says

As an advice-only planner, Ms. Brown sees her role as helping clients consider all factors on both sides of a decision so they can "make the choice that is right for them."

"Under advice from her accountant, Melissa has not claimed capital cost allowance on the condo and has elected under subsection 45(2) of the Income Tax Act to defer changing its use from her principal residence to an income-producing property," the planner says. She may do so for up to four tax years. "This means if she sells the condo within the next three years, she should be able to avoid paying any capital gains tax provided she and her accountant have followed all the eligibility stipulations."

At the end of the next three tax years, if she doesn't sell it, she may be able to increase the cost base of the condo to the market value at that time, rather than using her original cost, the planner says. Doing so would reduce the amount of capital gain on the eventual sale.

Melissa's rental income is $19,000 a year, or a 3.16-per-cent annual yield before tax, the planner notes.

"If we assume an appreciation in line with the rate of inflation, estimated at 2.1 per cent, this would provide her a total return of 5.26 per cent before inflation and taxes."

If condo fees and property taxes increase at a rate higher than the Ontario residential rent increase guideline, set at 2.5 per cent for 2024 and 2025, this will eat away at that yield and her annual income, Ms. Brown says. The increases would also likely affect the rate of appreciation of the condo. "Additionally, she will want to keep an eye on how much the property management company is increasing their fees each year."

At 65, when Melissa retires, she has an after-tax spending goal of $60,000 annually. Assuming an average tax rate of 20 per cent in her retirement, the rental income will provide her with $15,200 toward her spending goal.

Melissa plans to defer receiving Canada Pension Plan and Old Age Security benefits until age 70 to take advantage of the deferral bonuses, Ms. Brown says. Between age 65 and 70, she will need to rely solely on her investment portfolio to meet her spending needs. "Having regular rental income during that period could be a nice way to ease Melissa into the decumulation stage of life," where she draws down her savings rather than building them up, the planner says. "Many new retirees find it very scary to go from a regular monthly pay cheque to creating an income plan from their portfolio."

Melissa uses a financial adviser who manages slightly more than $1-million of her assets. "This managed portfolio has more than 65-per-cent exposure to Canadian equities and fixed income," the planner says. "If we add in her condo, this equates to more than 75 per cent of her assets exposed to the Canadian economy," she notes. "As Canada's economy represents a small fraction of the world's capital markets and gross domestic product, I would recommend she looks to diversify out of some of her Canadian exposure." Selling the condo and investing in markets outside of Canada could be a way of achieving this.

Melissa also has to consider the potential difficulty of owning property so far away and while she is out of the country. "One of Melissa's goals is to continue vacationing abroad annually and in retirement she would also like to escape to a warmer climate for a few months each year," Ms. Brown says. "Even though she will be paying a company to manage the rental for her, there can still be issues as a landlord she would need to deal with," the planner says. "Not being local could make it all the more complicated. I would encourage her to ask herself if she can see this bringing her any stress or anxiety at some point."

The planner looked at how each scenario would affect Melissa's retirement plan. Either way, she easily surpasses her spending target.

"Keeping the condo, we assumed her net rental income after all expenses can keep up with inflation at 2.1 per cent each year," Ms. Brown says. "In the scenario where she sells the condo, we assume this happens in 2027 and she invests the net proceeds in a non-registered account with a 50-per-cent fixed income and 50-per-cent cent stock portfolio and a 3.95-per-cent rate of return after management fees," she says. In both scenarios, taking into consideration her CPP and OAS income, and assuming that she lives to 95, Melissa could increase her after-tax spending goal to more than $100,000 per year, "with a high degree of certainty."

With a sound retirement plan, Melissa is in a fortunate position. She can make the decision about the rental condo based on the arithmetic, consider selling if the condo fees outpace her yield and price-appreciation rate or – to simplify her life – sell the condo and have the proceeds accessible for an increase to lifestyle spending or unexpected medical needs.

Client Situation

The people: Melissa, age 60.

The problem: Should Melissa sell her rental condo within the next few years or keep it as a long-term, income-generating investment?

The plan: Weigh the pros and cons, taking into account the potential difficulties of being a long-distance landlord. Selling and investing the proceeds would enable to her to better diversify her portfolio geographically.

The payoff: Knowing she has the financial flexibility to keep or sell the Toronto condo as she sees fit, and the potential to spend substantially more if she chooses.

Monthly net income: $6,333 salary, net rental income $895.

Assets: Condo $600,000; cash $75,000; TFSA $142,000; RRSP $690,000; registered pension plan $132,000; non-registered investments $213,000. Total: $1.85-million.

Monthly outlays: Transportation $100; groceries $1,000; clothing $100; vacation, gifts and miscellaneous $620; dining, memberships and entertainment $750; pet expenses $200; cellphone and internet $150; health care and wellness $200; pension plan contribution $150; RRSP $1,300; TFSA $585. Total: $5,155.

Liabilities: None.

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