THE GLOBE AND MAIL

June 22, 2012

Time for couple to change their game plan?

By LARRY MACDONALD

They are 'in great financial shape' but they wonder what will happen if he rolls the dice and starts his own business

Stan and Cheryl are in their mid-thirties, with two incomes and no kids. They're considering some big changes, and would like a few words of advice before they take the leap.

Stan wants to quit his job to start a business that buys and renovates residential properties for short- and long-term leasing. He's been doing renovations in his spare time for years, and has drawn up a comprehensive business plan for a full-time venture. Partly in preparation for the transition, he is on reduced hours from his work to renovate the dwelling that he and Cheryl inhabit.

Now that his employer is offering a generous buyout package, has the time come to switch fully into entrepreneurship?

Cheryl works for the same employer as Stan, and has every intention of staying until retirement – where a defined-benefit pension awaits. She also owns a townhouse rental, which they are thinking of selling in order to buy a vacation property – or a rental that would fit better with Stan's property business.

If they sold now, they would be relieved of the fixed-interest rate of 6.95 per cent on the mortgage. However, when it was taken out, a cash payment equal to 7 per cent of the mortgage was received from the bank, and it would have to be returned since they would be cancelling before the mortgage's expiry in 2014.

Finally, the couple wonder whether they are saving enough for retirement, and what impact Stan's career change might have.

We invited Marc Lamontagne, co-founder of financial planning firm Ryan Lamontagne Inc. in Ottawa, to comment on Stan and Cheryl's situation.

What the expert says

"Stan and Cheryl are in great financial shape," observes Mr. Lamontagne. "They should be commended for doing such a great job for a couple only in their thirties."

As for Stan leaving his job, "That's a tough one," says Mr. Lamontagne.

On the plus side, leaving now would give him some extra cash to fund additional property purchases. He'll get not only the buyout package but also a fairly substantial cash payment (just more than $50,000) representing the amount of his pension exceeding the limit specified by the Income Tax Act for transfers into locked-in registered retirement savings plans.

On the minus side, the lump sum of cash may push him into the top tax bracket, "therefore giving up a large portion to taxes." If he has any flexibility on departure date, "he may be better off leaving on Jan. 1, 2013, a year in which his income and subsequent taxes would be lower."

Another concern: "The building of a property portfolio that generates enough cash to live on ... will require more money than I believe he currently has," Mr. Lamontagne cautions. And with one income, it will be "a challenge to qualify for the mortgages needed." But Stan could be okay if he "finds a partner to help with the financing." Alternatively, the couple may be able to raise financing by reducing their personal consumption. A reduction of $1,500 a month in their spending will help free up capital for carrying mortgages on properties under development or being rented out.

As for the rental property, Mr. Lamontagne thinks it could be sold now. The annual rental income after operating expenses is generating a return of about 4 per cent on the value of the property. A return of 6 per cent should be targeted. "To avoid the mortgage penalty, they may be able to 'port' the existing mortgage [transfer it to the new property], and blend it with the current rate for any additional mortgage funds they need."

Buying a cottage is not a realistic goal if Stan quits his job. "They are going to need every last penny for the property business until such time as it is generating a good income."

As for retirement, Cheryl has few worries thanks to her pension plan. If she continues to maximize contributions to all her registered plans, she'll be able to afford large purchases – such as trips and cars – in her retirement.

If Stan stayed in his job, they would both be very comfortable in their senior years. But if he goes into business, retirement planning will be more of a challenge – in the early years, any spare cash tends to go into the business.

Lastly, if Stan opts for full-time property development and management, his goal should be to build a real estate portfolio that permits selling off enough properties to pay down mortgages on the remaining ones. "That way he can earn a steady income that, historically speaking, will keep up with inflation during his retirement."

Client situation

The people

Stan, 33, and Cheryl, 36

The problem

Deciding whether it is the right time to jump into self-employment and sell Cheryl's rental property, keeping in mind the ramifications for retirement years.

The plan

Stan can go full-time into property development and management if a financial partner can be found, or the couple can cut back enough on consumption (when quitting his job, he should try to leave early in the new year to reduce taxes). Cheryl's rental property can be sold to buy another rental with a better return on capital.

The payoff

The peace of mind that comes from dealing with, and resolving, major life decisions.

Monthly net income

$9,218

Assets

Non-registered savings and investments $63,500; registered savings $135,000; home $575,000; rental property $180,000; current value of pension plans, $285,000 (hers) and $115,000 (his). Total: $1,353,500

Monthly disbursements

Mortgage $2,336; condo fees $256; property tax $567; property insurance $115; electricity $188; gas $67; security $46; maintenance $750; garden $100; alcohol & tobacco $75; beauty $50; club memberships $72; dining out $300; entertainment $300; pet expenses $105; sports & hobbies $100; car insurance $52; fuel $111; maintenance $158; parking or transit $60; health care $32; groceries $571; clothing & dry cleaning $220; cell phone $105; Internet $64; gifts $200; charitable and other $225; vacation & travel $500. Total: $7,725.

Liabilities

Mortgage on residence $359,500; mortgage on rental property $93,500. Total: $453,000

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