Downsizing Your Residence

By Louis E. Conrad II, CFA

- Downsizing your home is usually driven by lifestyle and financial factors.
- You may find that your current home is too large or requires too much maintenance as you grow older.
- From a financial perspective, downsizing reduces your monthly expenses and allows you to extract equity from your current residence, which can be invested in your portfolio. This excess equity can then supplement the assets that are available to meet your retirement needs.

I have found that as clients age, many begin to consider downsizing their homes—that is, moving to a smaller and/or less expensive home. Lifestyle and financial factors are usually behind such a decision, which are the subject of this article.

Some of the more lifestyle-oriented reasons for downsizing your home are: (1) your children have finally left the nest and you have more space than you care to have; (2) you no longer find the same sense of enjoyment or fulfillment in maintaining your home or its exterior landscape; (3) you are becoming physically less able to function within your home and access to a first floor bedroom or handicap accessibility may become necessary; and (4) you are seeking a different climate for your retirement years.

According to a recent report sponsored by the Society of Actuaries, 38% of retirees and 45% of pre-retirees have moved or expect to move to a smaller home or less expensive area to help meet their retirement needs. For most people, home equity comprises the majority of their total assets and, as retirees, they may find themselves house rich, but cash poor.

Between the decline in access to pension plans, the lack of savings in 401(k) plans, and the stock market's poor returns during the Great Recession, more retirees are likely to tap their home equity than they have historically. The growth of your home's equity, through a combination of long-term appreciation, capital improvements, and the payment of mortgage principal, which can be viewed as a type of forced savings, can have a powerful and positive impact on your net worth. Tapping that equity can help offset a shortfall in your retirement assets.

Instead of a reverse mortgage, which was written about previously, downsizing your home can be an effective means of redeploying your equity. The goal is to take your existing equity, purchase a less expensive home with some of the equity, and add the remaining equity to your portfolio. The trade-off is that you are using your excess home equity to supplement your investment portfolio, which may carry more risk, but also more return potential than leaving the excess equity tied up in your residence.

The other financial reason many consider downsizing is to reduce their monthly living expenses, such as a mortgage, real estate taxes, maintenance, water and sewer, utilities, and similar expenses. Both the cash infusion to a portfolio from excess equity and the reduction in monthly expenses can have a significant positive impact on how long your retirement portfolio will last.

From a tax perspective, the first $250,000 of capital gain on your residence is exempt from tax as a single filer. If you are married, filing jointly, you have up to a $500,000 exemption. With both filing statuses, you must have lived in your home for at least two of the past five years to receive the exemption. Your home's cost basis is the price you paid for it, increased by any capital improvements that have been made since its purchase.

One final factor that I incorporate into retirement planning analyses for clients is whether they will downsize within state or move out-of-state. This decision will impact the amount of state taxes a client will ultimately pay.

The decision to downsize is an important one from both a lifestyle perspective, as well as a financial perspective. Your home's untapped equity could be used to supplement your portfolio and help offset any shortfall you would otherwise have in meeting your retirement needs.