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Leveraging Your Home Equity in Retirement

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Retirees have several options for using a home's value to assist their finances.

Even after decades of saving, most retirees find that their home is still their single biggest asset. And yet the question of what to do with a primary residence in retirement is often presented as binary: Stay put or sell?

If you decide to stay in your home, it's generally wise to pay off a mortgage before you retire, which will help establish a strong financial footing later in life and give you much more financial freedom.

But staying put doesn't mean you can't leverage your home's value in retirement. After paying off your mortgage or building up equity in your home, you could consider renting it out or tapping the home's equity to adapt your home for easier use as you age.

Though such moves can make sense, each carries its own risks. You may be tempted to treat your home as a bank to support your retirement, but like everything else in life, it pays to plan ahead and weigh all your options.

Here are the three most common ways to tap a home's value during retirement.

Many retirees relocate or downsize due to climate, cost of living, or for family or health reasons. Despite the emotional attachment to the family home, retirees may find that their house doesn't suit their lifestyle as they grow older, or they may no longer need the space —never mind the rising expenses such as maintenance, insurance, and property taxes.

Before you put your house on the market, however, it's important to understand the potential capital gains tax liabilities. Sellers can exclude the first $250,000 in profit ($500,000 for married couples filing jointly), provided they've owned the house and used it as a primary residence for at least two of the past five years.

You can calculate capital gains from a home sale by subtracting your cost basis from the selling price. The cost basis includes not only the price you paid for the house but also certain closing costs and settlement fees, along with the cost of any major capital improvements (as opposed to simple repairs), such as additions, a new roof, and even

landscaping. It can also include home insurance reimbursements you received for casualty losses, as well as real estate taxes or other costs you paid on behalf of the seller when you first bought your home. That's why it's important to keep good records, including receipts, if you want to take advantage of the kinds of improvements that can increase your cost basis—and therefore lower your tax bill. IRS Publication 523 outlines eligible expenses that can be factored into the cost basis.

If you don't plan to live in your house, renting it out can provide another source of income while preserving the option of returning to it later or passing it down to your heirs.

A rental property can provide not only income but also potential tax benefits. For example, you may be able to deduct certain expenses, such as depreciation and repairs, from your annual rental income. Keep in mind, however, that any taxable rental income could potentially push you into a higher tax bracket or impact how much you pay for Medicare premiums.

You'll also want to ask yourself whether you want to be a landlord, which means that you'll need the time and energy to maintain the home, manage the tenant, and abide by any homeowners' association rules or local rental laws. Finding a good property manager

can help, though it can also eat into your rental income —typically around 10% of the monthly rent. Also, you'll want to consider setting aside 1% to 2% of the home's value to avoid having to sell securities in a down market to pay for any unexpected expenses.

Finally, if you're considering renting out your home, it might be helpful to treat it as a separate business entity. Registering your rental property as a limited liability company (LLC), for example, can help protect your other assets in the event you're sued—as can liability insurance.

Though you can borrow against the value of your home using either a home equity line of credit (HELOC) or a home equity conversion mortgage (HECM), they serve very different purposes.

A HELOC

allows you to borrow against the equity in your existing residence—and you can deduct interest on up to $750,000 in total mortgage debt if you use the funds to purchase, build, or substantially renovate a primary or secondary residence. If your goal is to repair or enhance the value of your home before a sale, then a HELOC can be a good option. However, using HELOCs to fund ongoing expenses can be a concern.

Generally, you're better off living within your means and not using a line of credit to support vacations or other nonessential expenses that don't improve your home. HELOCs generally have variable interest rates, meaning that your scheduled payments could rise due to economic conditions beyond your control. Other risks include having negative equity on your home should its market value drop below the total amount you owe, and—if you fail to make payments—foreclosure of your home.

A HECM

is a type of reverse mortgage that allows older home ownersto hold on to their home while leveraging some of its value for interim expenses. HECMs use a home's equity to offer people age 62 or older the choice of a fixed monthly payment, a lump sum, or a line of credit that doesn't require regular loan repayments like a HELOC or a standard mortgage. Instead, it adds accrued interest to the balance, and the loan doesn't have to be paid off until the borrower moves, sells, or passes away. HECMs are insured by the Federal Housing Administration (FHA), so neither you nor your heirs will have to pay back more than the home is worth. On the other hand, it also means putting some of your home equity toward the loan's fees and interest payments. HECMs generally have higher associated fees—such as mortgage insurance premiums—than traditionalmortgages

In addition, because a condition of all HECMs is residency in the home, seniors run the risk of having to pay the entirety of the loan should they happen to be hospitalized for more than 12 months, for example. Failure to pay the loan could lead to foreclosure. Other conditions that could lead to foreclosure include failure to pay property taxes and insurance, and inability to keep the home in good repair. HECMs can provide flexibility to retirement income strategies. For example, if you want to avoid tapping your portfolio during a down market or you require emergency cash beyond what you have on hand, a HECM could be a good fit. What's most important is to be strategic with its use. There's always a cost to borrowing, and HECMs are no different.

If you are considering a HECM, you're required to talk with a federally approved housing counselor to fully understand your options and responsibilities. In addition, your wealth advisor can also help you think through the implications across different areas of your financial plan.

If you're a retiree with substantial equity in your home, you may be tempted to sell in order to augment your savings—particularly if you're lucky enough to live in a desirable real estate market. But don't lose sight of the fact that your house is also a home with an emotional value.

Even if you've run the numbers and are selling for all the right reasons, it's important to weigh all your options well in advance, so your decision not only makes the most financial sense but also is the one with which you're most comfortable.

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