

Getting Value in a Vacation Home

Considerations before making a purchase

Topical Education for Today's Investor

LIFE MANAGEMENT

There are two great reasons for buying a vacation home: **You want one and you can afford to buy it.** Buying a vacation home as an investment, however, should not be your primary motivation.



Some vacation properties can also be good investments. Others aren't. Despite what some real estate agents may tell you, there are no guarantees — the recent struggles of the U.S. housing market have helped illustrate that point. There are, however, some guidelines that can help you find a vacation home that will provide value along with pleasure.

The Rules Have Changed

Consider first whether you want to buy or rent and, if you choose to buy, where and how. There was a time, back before tax-reform legislation in the 1980s, when there were compelling tax advantages to financing a second home. You're still able to deduct mortgage interest on one such home; but, unless it is income-producing property with its attendant complications, the once-valuable depreciation write-offs are gone. To help decide whether buying a vacation home is right for you, consider the following.

How Often Would You Use the Property?

If you plan to spend just one week, or even two, out of every 52 at a vacation home you purchase, you would probably be spending a lot of money for each day there. Mortgage payments continue all year long, as do payments for insurance, taxes, and necessary

regular maintenance. If you'd be paying full price but getting only part-time use, consider renting.

There are good reasons for buying a vacation home, not the least of which is a simple desire to own the place and do what you want with it. But renting lets you experience vacation life in different places, and is relatively affordable. Rents can run from \$1,000 to \$10,000 a week or more, depending on location and amenities. At the end of your stay you close the door and forget about the place. Financial planners say that if you're just looking for a few weeks of vacation a year, it's probably cheaper in the long run to rent. An extra attraction to renting is that it gives you a chance to test different locations before settling on one to buy.

How Desirable Is the Location?

The old real estate saying goes like this: "What are the three most important things about selling a house? Location. Location. Location." The same holds true for a vacation home. Are you looking at a simple cabin in the backwoods or a comfortable house or condo in or near an attractive resort area? A rural hideaway may be great for hunting, hiking, or just getting close to nature, but don't expect its value to appreciate as fast as a more comfortable place located near amenities.

With the graying of the Baby Boom generation, some analysts predict an increasing demand for vacation homes in the future. That great population bulge has rapidly approached an age when many can be expected to spend the money they've been working for and take life a bit easier.

Keeping that in mind, the best investment for future resale would probably be a fully equipped getaway that could double as a second home, perhaps on waterfront property or with privacy-protecting acreage. Amenities are important. Younger people often don't mind minor inconvenience, but older people look for quality construction, high end appliances, and luxuries such as hot tubs. That condominium on the ski slopes should not be "bare bones."

Mortgage Tips

- A 10% or greater down payment is required.
- Small down payments (of 10%) also mean paying more in private mortgage insurance than with a primary residence
- The property must be a single-unit dwelling or condominium that is occupied by the owner for a portion of the year and unencumbered by a time-sharing ownership agreement.
- Borrowers cannot currently own rental property in the location of the vacation home.
- The property must be suitable for year-round occupancy.

You Don't Have to Be Super Affluent

The vacation home doesn't have to be a stand-alone house. A condominium purchase can let you have a home in a terrific location that would be otherwise unaffordable. Although vacation home values rose steadily for the first half of this decade, prices in some areas fell significantly during the 1990 recession, which came on top of tax-law revisions, leaving many people with mortgages bigger than the sales values of their properties. Some speculative buyers of recent years are experiencing similar challenges today.

For value today, look for that house, condo, or timeshare in a location that has activities in more than one season. Keep in mind, too, that vacation properties often become retirement homes. So safety, taxes, and the availability of cultural opportunities should be considered. With those things in mind, look for bargains in lesser-known places; investigate upswing markets, places that haven't yet become overrun or overpriced.

Look for areas where the local economy is strong and taxes are low. You don't have to be near a city, but you should be within a reasonable distance of populated areas to have access to services like quality medical care. Another reason for being near more populated areas is that such a location allows you the opportunity to try to rent out your property when you're not using it to help cover mortgage payments and, perhaps, sell at a profit later on. With the right choices, returns can exceed the future payoff from stocks.

Tax Considerations

If you rent your home for 14 days or less a year, you do not need to report the rent. Beyond that, however, the IRS considers the rent taxable income. But you may then be able to deduct all of your rental expenses if you had a net profit on the property (deductions are limited if you report a loss). These are guidelines only; your specific tax obligations should be discussed with a qualified tax advisor.

- You can deduct mortgage interest on two houses, to a limit of \$1 million.
- You can rent your vacation home for up to 14 days without having to report the rent as income; if you rent for more than 14 days, the home is considered investment property and rent must be reported as income.
- Rental deductions are based on the portion of the year the property is rented.
- You can use the property for the greater of 14 days or 10% of the total days it is rented and maintain your tax advantages. Maintenance days do not count as personal-use days but should be documented. Use by in-laws or other part-owners counts as personal use even if rent is charged.

Source: Internal Revenue Service.

Know Your Goals

For many affluent families and individuals, owning a vacation home is an important lifestyle goal, reflecting their hard work and success. With proper planning, a vacation home is a realizable dream that can bring years of happiness. But there are significant issues to consider and other important goals to balance, so it is important to work closely with a financial advisor to help construct a personal plan specifically designed to help you achieve that vacation home dream.

Points to Remember

1. Buying a vacation home as an investment should not be your primary motivation.
2. If you plan to use the property for only a week or two each year, consider renting rather than owning.
3. When buying, the most important factor is location. Look for a site near resort areas or amenities. Added features such as quality construction, high end appliances and luxury items can make it easier to sell the property later on.
4. Look for areas that offer year-round activities. If you plan to use the home as a vacation home, look for access to services, protection, and cultural activities.
5. You can rent your property for 14 days and keep the income tax free. If you rent the property for more than 14 days, you may be able to deduct the rental expenses depending on whether you report a profit. See your tax advisor for complete information on your circumstances.
6. A vacation home can be a realizable dream for many, but should be balanced against other important financial goals. A professional financial advisor can build an investment plan to help you achieve your specific goals.

For more information, please contact your financial advisor.

Important Additional Notes

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