



## FINANCIAL ISSUES OF OWNING A VACATION HOME

Like many retirees and Baby Boomers approaching retirement, you may dream of owning a vacation home. With today's low interest rates, a still healthy economy, and smaller down payment requirements, that might become a reality, even if you are a middle-income family. But before you head off to the mountains, the beach, or the lake to buy your vacation home, keep these financial issues in mind.

**A home, not an investment.** Most experts recommend buying a vacation home because you love it, not because it is potential investment property. It may appreciate in value substantially, but there are usually better and easier ways to invest in real estate. If resale is a concern, location will be paramount. Property near a beach, lake or mountains tends to be the most popular.

**The cost of buying.** While bargains may be had, vacation homes tend to be expensive. You may need to juggle two mortgage payments, which can have a major impact on your overall financial picture. Although mortgage rates are low these days, rates for a second home may run a little higher than for a first home because the default rate on second-home mortgages is higher. Homeowner's insurance can be high, too, because vacation homes often are located in high risk areas such as flood and earthquake zones, and remote locations are more vulnerable to theft and fire.

**The cost of maintenance.** Things need repair in any home, but it can be more challenging in a vacation home because of distance. If you can't get there yourself, you'll need to pay someone. An added expense is security systems, which tend to be more common in vacation homes. And you'll have the extra cost of furnishing a second home.

**The cost of renting.** Are you assuming you can pay for the property by renting it out? Good luck. Usually rental income won't cover all the cost of your mortgage, taxes, insurance, and maintenance. But it can help. The problem with renting is that for many people it's a hassle. First, you've got to find renters, and then you have to deal with such issues as rent payments and damage. Do you play landlord yourself, which is especially difficult if you live far away, or pay a professional company to rent it out?

**The taxes of renting.** If you rent out your home, you may need to add in the cost of an accountant. The tax rules for rental property are extraordinarily complex. Keep in mind the magic number of 14. If you rent out your second home for 14 days or less, you don't report the income. On the other hand, you can't deduct expenses incurred for renting it out.

If you rent out the home for more than 14 days, you can deduct expenses. The deduction will be limited, however, if you use the home for personal reasons for more than 14 days a year, or if at least ten percent of the total rental days are for personal use. The limitation is that you can't deduct expenses that would create a loss. For example, say you earn \$12,000 in rental income, but expenses are \$14,000 (mortgage interest, property taxes, insurance, property management fees, etc.). You can deduct \$12,000 in expenses, but not beyond that.

If you don't use the vacation property more than 14 days, or your personal use is less than ten percent of your total rental days, the property is considered rental property. You then may be able to deduct up to \$25,000 a year in net losses. This deduction for what's called "passive losses" begins to phase out once your adjusted gross income (AGI) reaches \$100,000 and it disappears at \$150,000 of AGI. There also are other complicated rules about the order in which you can deduct expenses, how personal days are counted, and so on. At this stage, you'll need an accountant or other tax expert.

**Capital gains exemption.** Generally, you can't take advantage of the capital gains exemption of up to \$500,000 from the sale of your vacation home. To do so, you would need to make it your principal residence for at least two years.

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