Investment Guide

Buy Now, Retire Later

Kerry Hannon, 06.08.11, 06:00 PM EDT
Forbes Magazine dated June 27, 2011

If you've got cash, pick up a future resort retreat now at a bargain price.

Dazzled by the price and the view, Linda and Patrick Gallagher scooped up their Virgin Islands villa years before his retirement.

This past February Linda and Patrick Gallagher fell in love with the dazzling Caribbean view from a two-bedroom villa perched on the hillside above St. John's Cruz Bay in the U.S. Virgin Islands. They scooped up the property, which had been listed for as much as $1.495 million, for only $960,000--all in cash.

The Katonah, N.Y. couple bought the villa, called Perelandra, as a *future* retirement home. While Linda, 57, retired last year from her job as a school librarian, Patrick, 60, plans to work a few more years as chief financial officer at the public relations firm Robinson Lerer & Montgomery. "The price was the impetus to buy now," Linda says. "We had vacationed there several times, so we knew the island and had been looking for over a year. We realized that if we waited, and prices came back up, we wouldn't be able to do it. So we sold stock and bought. It felt like paradise."

The Gallaghers aren't alone. The housing crash is grim news for those who need to sell their homes to retire. But it's also an opportunity for well-off boomers to buy marked-down properties in attractive resort areas they want to move to--or at least spend more time in--once they dial back their working hours.

According to the *2011 National Association of Realtors Investment and Vacation Home Buyers Survey*, vacation-home buyers in 2010 had an average age of 49, and 34% planned to use the property as a primary residence sometime in the future. If you're looking to pick up a bargain retirement home now, here are some pointers.

Prices are near a bottom

Last year the median sales price of vacation homes was $150,000, down 11% from $169,000 in 2009, according to the NAR survey. Mark Zandi, chief economist with Moody's (MCO - news - people) Analytics, predicts that housing prices will drop another 5% this year before hitting bottom at year's end. But the timing will vary by market. Florida retirement spots, including Fort Lauderdale, Cape Coral and

Naples, aren't expected to bottom until 2012, reports Moody's housing analyst Celia Chen. But other popular second-home locales, including Bend, Ore.; Coeur d'Alene, Idaho; San Luis Obispo, Calif.; Flagstaff, Ariz.; and St. George, Utah should see the bottom this year--meaning now is the time to start looking.

Cash is king

Nearly 40% of vacation home buyers paid cash in 2010, up from 29% in 2009, according to the Realtors. Forget about buying with 10% down; among second-home buyers who took mortgages, the median down payment was 32%.

Since getting a mortgage for a second home is now a slow and iffy process, a buyer ready to pay cash is likely to snag a better deal. "This is the greatest time ever for the cash buyer," crows real estate attorney **Adam Leitman Bailey**, author of *Finding The Uncommon Deal: A Top New York Lawyer Explains How to Buy a Home for the Lowest Possible Price* (Wiley, 2011). It's not just the prospects of getting a bargain that motivates cash buyers. Says **Bailey**: "My clients figure they're not making money in the bond market. They don't trust the stock market, and the interest is so low on their bank accounts it's not worth keeping cash there. So they are floating money into real estate."

Cash rules supreme in tonier areas. In the Village of Westhampton Beach on New York's Long Island, for example, more than 50% of deals are for cash, estimates Steve Rosmarin of Kerrigan Country Realty. At the end of January a four- bedroom oceanfront property sold for $1.76 million cash, down from the original listing price of $2.45 million. The seller was "motivated," Rosmarin chuckles. "It's the people who have cash to spend who are snapping up the better properties," reports Robert W. Bennington, a broker in Sunriver, Ore., a resort in the foothills of the Cascades where prices run from $250,000 into the millions.

It's location and condition

The old real estate buying adage--location, location, location--is particularly true with vacation homes. **Bailey's** advice: Stick with places with views--the beaches, the sea. Look, too, for locations with good public transit or paratransit and convenient medical facilities; with boomers aging, those areas will serve you--and potential buyers--better.

A distressed-priced property may have been neglected, so pay close attention to the engineer's report of necessary repairs. Still, buying a fixer-upper can work out, if you know the market and what you're getting into.

Last year Oceanside, Calif. artist Diana Tollenaar, 61, bought in a short sale (for less than the seller's mortgage balance) the property she plans to retire to. She paid $20,000 below the $160,000 asking price for a two-bedroom, 1,540-square-foot town house in Green Valley, Ariz., at the base of the Santa Rita Mountains near Tucson. Then she sank $20,000 into improvements. "I've been spending winters in that community for ten years, so I knew the area attracts snowbirds from Minnesota and Michigan eager for rentals, and the price was just so good," she explains. "I figured the investment was worth it to make the house more comfortable as a rental and a potential home for me in a few years." For now she rents it out for $650 per week, or $1,995 to $2,250 for monthlong stays.

You're a landlord now

Buying a retirement home at a rock-bottom price now is less attractive if you have to eat the full cost of owning two homes until you retire. That means you'll probably want to become a landlord. Until Patrick retires the Gallaghers plan to vacation at their Caribbean villa for only three to four weeks a year and to rent it out for $2,240 to $4,725 per week (depending on the season) the rest of the time.

To attract tenants, particularly in a posh market, you'll need to spend on landscaping and exterior face-lifts, along with one-time expenditures for furnishings, appliances and electronics. So don't use up all your cash on the purchase.

If your vacation property is far from your primary home, a good property manager is indispensable. A professional manager should arrange for maid service, lawn care and emergency support--say, finding a local plumber if the pipes burst. A manager/agent can also find renters, but the cost for such all-inclusive service can be stiff--running from 20% to 30% or more of rental income.

Alternatively, you can hold down costs by paying a lower or flat fee for on-site property management and finding and screening prospective tenants yourself. You can list your property online for $240 a year at Tripadvisor.com, $300 a year at Vacation Rentals by Owner (VRBO.com) or $329 at its sister company HomeAway.com. Talk to each prospective renter, ask questions and do a little Internet sleuthing via Pipl.com, a people search engine, or Google (GOOG - news - people), LinkedIn and Facebook. Require payment (with a refundable security deposit) well in advance to make sure the payment clears.
Does Web marketing work? Linda Gallagher, who is using HomeAway, reports her calendar is filling up faster than she anticipated. "It looks like we'll be able to cover expenses for the next year, at any rate," she says.

Tax torture

The tax treatment of your future retirement home varies depending on how many days you rent it out and how many you use it. The simplest situation: If you rent it out for 14 or fewer days a year, you can pocket the rental income tax free while claiming all mortgage interest and taxes as itemized deductions on Schedule A of your 1040, just as you do for your primary home. (Under current law interest on up to $1.1 million in original acquisition mortgage debt from a primary and a second home is deductible.)
If you rent out the home for more than two weeks, all rental income must be reported and life gets more complicated. Assuming you use the house yourself (or allow nonpaying family and friends to stay there) for more than two weeks and for more than 10% of the total days it is occupied, the house is still considered partly a personal residence, and expenses are allocated between your personal use and your rental sideline.

Get this: There are two methods for allocating expenses. The IRS' approved method ignores days when your property is empty. So if you rent the property out for 120 days and stay in it for 60 days, two-thirds of all the expenses for upkeep, utilities, mortgage interest and taxes get deducted against your rental income and a third of mortgage interest and taxes are deducted on Schedule A. But a second method (backed by a court decision) counts empty days as personal use. Either way, upkeep for personal use isn't deductible, and you can't claim a loss on the rental portion.

What if you use the home fewer than 14 days a year or less than 10% of the days it's occupied? Then it's an investment property, and you can deduct even more expenses, including depreciation of the physical property, against rental income. That means you might have a loss that you can use to offset other taxable income. We say "might" because taxpayers with adjusted gross income above $150,000 can't use any of the "passive losses" from rental real estate to offset their "nonpassive income" such as salary. Confused? Take a look at IRS Publication 527, and spring for a tax pro--at least at the start of your stint as a landlord.