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SHOULD YOU INVEST IN A SECOND PROPERTY? Some special considerations in purchasing non-principal residences

If you've been thinking about buying an investment property, market conditions are definitely in your favour. Mortgage rates remain very attractive and with good inventories of lower-priced properties it's hard to go wrong — unless, of course, you lack the financial means to make the investment. After all, you'll have to meet *all* the obligations that come with owning more than your principal residence.

It's a big investment in time and money. You not only have to consider the mortgage payments, but the costs of maintenance and property taxes. You also have to deal with tenants on an ongoing basis and be able to mediate any disputes that may come up. But the investment has paid off handsomely for many second-home owners.

LEVERAGE

Secondary home ownership is an attractive investment option because it gives you even more leverage than you have with your principal residence. Leverage is when a relatively small amount of your money controls a much larger asset — like a property.

The more leveraged you are, the greater the financial return on your down payment becomes if the value of your property increases. There are very few other investments which can be purchased with such a small percentage of your own money!

For instance, let's say you acquire a second property for \$100,000, with a \$25,000 down payment, and during the first year that you own it, the property increases by a value of three percent for a \$3,000 gain. As a result, the return on your down payment of \$25,000 is 12 percent.

By comparison, let's say you were to buy a term investment of \$100,000 (in cash) for one year and it increased by \$8,000 over the course of the first year. Since it cost you \$100,000 in cash to buy it, the return on your investment is only eight per cent before taxes. Obviously, leveraging is a powerful way to make your money work for you.

CAPITAL GAINS

You should be aware that while you are allowed an exemption on capital gains — the amount your home increases in value — for your principal residence, you can't claim capital gains exemption on investment or recreational properties purchased after February 1992.

The capital gains exemption was eliminated for dispositions of other forms of investment occurring after February 22, 1994. This change, while not popular with some, has in fact placed real estate investment back on a level playing field with other forms of investment.

GETTING FINANCED

Many lenders place non-owner-occupied deals in the high-risk category and it's not that unusual to find lenders who are reluctant to finance rental units at all — or those who will only finance them if they are insured.

Lenders will want to know whether the property will carry itself. Is there sufficient rent to cover the mortgage payment? How much maintenance and repair will be needed in the short-term and mid-term future?

Don't make the mistake of assuming that a rental income of \$500 per month will carry a mortgage payment of \$500 per month. Only a portion of the rent is used to pay the mortgage; the remainder must cover taxes, maintenance, vacancy, bad debt and expenses.

Also, to determine your eligibility, lenders will consider the rent you will charge as income and it will be added to your other sources of income. They will look at your monthly housing expenses, which shouldn't exceed approximately 30



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per cent of your monthly gross family income. This is called your “gross debt service” ratio, or GDS. Some lenders will, in fact, go as high as 35 per cent, depending on a number of variables.

Lenders also use a second calculation in qualifying you for a mortgage. It’s called the “total debt service” ratio or TDS. Generally speaking, no more than 40 per cent of your gross family income may be used to cover mortgage payments, property taxes, utility costs, *plus* other fixed monthly payments. These other fixed costs are your ongoing commitments and can include auto, personal loans as well as charge accounts.

COSTS

You should be aware that the cost of obtaining a mortgage (for legal and appraisal fees) on a non-owner-occupied property with more than one unit — such as a duplex or triplex — could be higher than the cost of obtaining a mortgage on an owner-occupied property.

Interest rates charged on rental properties might also be higher because some lenders view these properties as being a higher risk.

As mentioned above, the main responsibility of having a second property is being able to carry it financially. And if you’re like most people, you’ll probably have to rent it to someone to help with the costs.

This is also a big responsibility because you will have to maintain the property in addition to your own home, and you’ll be responsible for finding tenants you trust and with whom you feel comfortable. Some parents with grown children who are ready to go off to college or university choose to purchase secondary properties for their children to live in while they attend school. This gives the parents an excellent investment and they are assured that the occupants will take good care of the home. If you’d like more information about purchasing a second property, consult your REALTOR.

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