THE VACATION INVESTMENT

BY NANCY DUNNAN

A cottage on a sandy beach, a condo in Spain or a ski house nestled in the mountains. A second home may be the new American dream.

But is it still a good investment, especially after tax reform? The rules have changed, as we all know, but the answer is "yes," provided you understand the new guidelines and don't overpay.

In fact, the 1986 Tax Reform Act was kind to homeowners but rather harsh to traditional real estate tax shelters. Those designed to generate large paper losses or tax write-offs were largely eliminated, leaving direct investing in property as one of the few tax-advantaged investments left.

Low mortgage rates make this a good time to look at second homes. In many areas prices are down by 10-15 percent, or even more. And second homes continue to offer a myriad of advantages, not the least of which is providing a vacation spot for your family. However, you must plan its use carefully.

Your first consideration should be location, which is as important as price. The best investments (and also the most expensive) have unique locations. Yet if you're willing to be flexible, you can shave dollars off the purchase price by being near but not on the ocean, by being within hailing distance of the ski lift but not directly adjacent to it.

Experts suggest looking for a house within two hours of a major city or metropolitan area. Anything farther is too far to be an easy weekend retreat, which in turn makes it more difficult to rent or resell. Excellent buys can often be found in towns immediately next to chic spots. Eventually the overflow will boost their property values.

Your second consideration should be the IRS, especially if you plan to rent out your retreat to cover costs. Under the new rulings, your deductions will be based on whether your second home is classified as "residential" or "rental."

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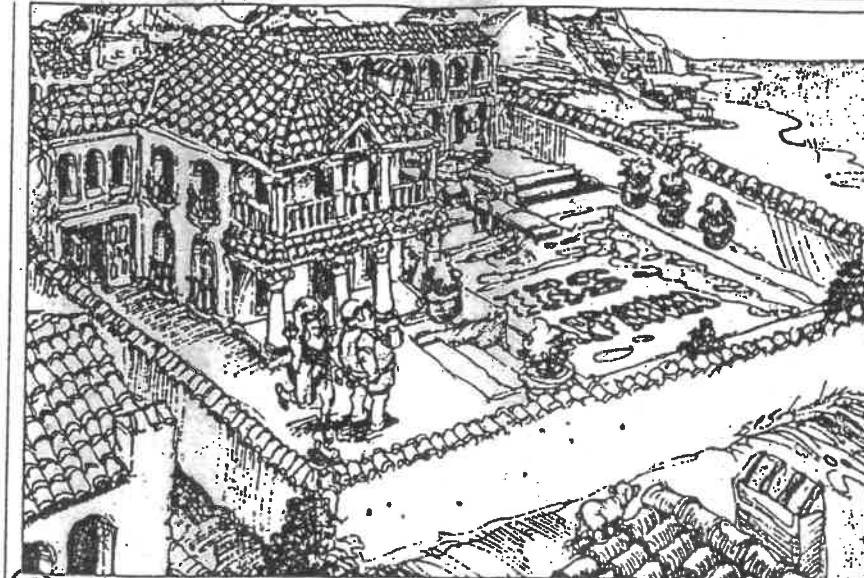

1 If you rent your vacation home less than 15 days per year and use it yourself or leave it vacant the rest of the time, you don't even need to report that income to the IRS. And you can still deduct your mortgage interest, real estate taxes and certain casualty losses.

2 If you rent for 14 days or more and use the house 14 days or more, or 10 percent of the time it's rented, then your rental expenses are also deductible. Keep track of them, because they're deductible only up to the amount of your total rental income. Of course, your mortgage interest and property taxes are deductible.

RENTAL VACATION HOMES

3 If you rent for 15 days or more and your personal use is less than 15 days or 10 percent of the time rented, then your home is rental property. The expenses you incur in excess of your rental income, as well as property taxes and mortgage interest, are deductible.

Congress carved out an interesting law that aids those with an adjusted gross income of $100,000 or less. Those in this category who actively manage rental property are allowed to deduct up to $25,000 in losses against other income. The $25,000 limit is gradually phased out for those in the $100.000 and up bracket. By the time it reaches $150,000, the deduction is eliminated.

To qualify as an active manager is quite simple: You must own at least 10 percent of the property and make decisions on tenants, rents and maintenance. Keep in mind that any losses not currently deductible may be carried forward and used against passive income.

Financing a second home may be easier than you think. First of all, consider buying with a friend, another couple or a family member. This could reduce your expenses by 50 percent. The most common and trouble-free arrangement is a 50-50 division of down payment, taxes, mortgage payments, costs and use of space.

Be sure to work out in whose name the mortgage and title will be held, how payments will be divided, who may use the house and when, how nonpaying guests will be handled, what to do if one party wants out, and how a default of payment will be taken care of. A contract clause describing how disagreements will be resolved is crucial.

If you already own a house, you may be able to refinance it at a lower rate than you're now paying. This frees up cash for a down payment. Most lenders will give up to 80 percent of a house's appraised value in a mortgage. ■