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Plan carefully before buying second home; Have a financial plan before investing in a recreation property

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Illustrations: Colour Photo: Hugh Wesley, For Canwest News Service / Financial adviser Heather Holjevac, who owns a vacation property, knows questions to ask yourself and your banker before taking on extra debt at the right for a recreation or investment property.

Heather Holjevac enjoys crunching financial numbers for her clients, but one of the most engaging financial planning exercises she's undertaken has been personal.

In 2007, Heather, 44, and her husband Joe debated whether they could afford a second property in Sauble Beach, Ont., near Lake Huron, where the couple could eventually retire. If they decided to buy it, it meant taking on a new six-figure mortgage.

They looked at the merits of a second property compared with other financial strategies such as putting more money in RRSPs or non-registered funds, says the Mississauga, Ont.-based financial planner and tax consultant.

Ultimately, they decided to buy the property. The Holjevacs believed the property could appreciate in value and be a place they could occupy in 10 to 20 years.

They could afford to make enough of a down payment to eliminate the cost of payments to Canada Mortgage and Housing Corp. for insurance and fees, and then obtain an affordable mortgage.

"The clincher, basically, was the rates at the time, because we got a variable mortgage, which was prime minus a half point, so currently our rate on that is 1.75 per cent," Holjevac says.

Purchasing a first home is often touted as the biggest financial investment an individual will ever make.

But many people decide to purchase another property for recreational or investment purposes. That, too, is an enormous investment and something that requires a great deal of financial planning.

Before proceeding, there are a number of mortgage-related questions that need to be considered and discussed with the assistance of a financial professional, say the experts.

"People need to consider, 'How does this impact my budget?'" says Gary Siegle, a regional manager in southern Alberta and Saskatchewan for the mortgage brokerage firm Invis.

When discussing the purchase of a recreational property, for example, "as mortgage professionals we sit down with them and do a series of calculations" to determine if they qualify for a mortgage, and if so, the monthly payment they can afford.

Generally, the mortgage broker looks at two different ratios to determine an applicant's qualification for any mortgage, says Tracy Irwin, a broker with The Mortgage Centre in Stoney Creek, Ont.

First, they calculate the gross debt service ratio, which includes the principal and interest on the mortgage payment, plus property taxes and heating costs, divided by monthly income; the total should not exceed 32 per cent.

Second is the total debt service ratio, which includes calculations for all of the gross debt service ratio items, plus the carrying costs of all other liabilities that mortgage candidates are making payments on, such as car payments, outstanding credit card balance, or on an outstanding line of credit, divided by monthly income. That percentage should not exceed 40 per cent, but can go as high as 44 per cent with a good credit score, says Irwin.

Determining how large a mortgage is affordable for an investment property is different than for a recreational property.

"An investment property is generally seen as the type of property that you're going to be using to realize some sort of capital appreciation or future income stream," says Scott Plaskett, a certified financial planner and chief executive officer with Ironshield Financial Planning in Toronto.

If it's a mortgage for an investment property with a rental component attached to it, some of that income can be offset as a deduction to the arithmetic formula used when the lender calculates the potential mortgagee's total debt service ratio.

Currently, up to 80 per cent of gross rental income is eligible to be offset, but that offset will be reduced to only 50 per cent effective April 19, as a result of recently revised mortgage rules announced by federal Finance Minister Jim Flaherty.

This will impact investment property mortgage applicants, because under the tougher new formula requirement, they will require additional cash flow to qualify for that mortgage, says Irwin.

The cash required for a down payment on an investment property before a mortgage is taken out will also change on April 19; the minimum down payment for a property under five units (i. e. a

non-commercial property) will increase from five per cent to 20 per cent.

With an owner-occupied residential property, however, the minimum down payment will remain at five per cent.

Government-backed mortgage loan insurance needs to be purchased for loans with down payments of less than 20 per cent.

Mortgage interest paid on debt incurred to purchase an investment property is tax deductible against the income from the property.

This can allow the owner to carry a larger mortgage than he or she could for a comparably priced recreational property.

In contrast, "on recreational property, the goal is to carry as little debt as possible because you're not getting any benefit from the interest you're paying on that," Plaskett says.

Rental income from an investment property -- or a recreational property that is being rented out -- can help defray mortgage payments.

There is risk, however. During periods of vacancy, the entire mortgage will have to be carried by the owner.

There could also be times when problems surface, such as a leaky roof that has to be replaced.

"That's why when you're operating a rental property or investment property in a profit position, we always recommend to stockpile that profit into a cash reserve to cover any future expenses that may come up," Plaskett says.

But, he adds, in the long term "you've got a nice asset that's going to continue to pay as long as the rent keeps coming in."